No. 06-666

Title:	Department of Revenue of Kentucky, et al., Petitioners v. George W. Davis, et ux.
Docketed:	November 15, 2006
Lower Ct:	Court of Appeals of Kentucky
Case Nos.:	(2004-CA-001940-MR)
Decision Date:	January 6, 2006
Discretionary Court Decision Date:	August 17, 2006

Questions Presented

| ~~~Date~~~ | ~~~~~~~~Proceedings and Orders~~~~~~~~

Jul 19 2007	Brief of petitioners Department of Revenue of Kentucky, et al. filed.
Jul 19 2007	Brief amicus curiae of National Federation of Municipal Analysts in support of neither party filed.
Jul 19 2007	Brief amicus curiae of Securities Industry and Financial Markets Association filed.
Jul 19 2007	Brief amicus curiae of Dupree Mutual Funds filed.
Jul 19 2007	Brief amici curiae of North Carolina, et al. filed.
Jul 19 2007	Brief amici curiae of Government Finance Officers Association, et al. filed.
Jul 19 2007	Brief amicus curiae of Multistate Tax Commission filed.
Jul 19 2007	Brief amici curiae of Churchill Tax-Free Fund of Kentucky, et al. filed.
Aug 7 2007	The time to file respondents' brief on the merits is extended to and including September 21, 2007.
Aug 30 2007	SET FOR ARGUMENT Monday, November 5, 2007.
Sep 20 2007	CIRCULATED.
Sep 21 2007	Record received from the Supreme Court of Kentucky. (1 envelope)
Sep 21 2007	Brief of respondents George W. Davis, et ux. filed.
Sep 21 2007	Appendix of George W. Davis, et ux. filed.
Sep 21 2007	Brief amicus curiae of Tax Foundation filed.
Sep 21 2007	Brief amici curiae of Alan D. Viard, et al. filed.
Oct 10 2007	Record received from Jefferson County Circuit Court. (1 box)
Oct 26 2007	Reply of petitioners Department of Revenue of Kentucky, et al. filed. (Distributed)
Oct 31 2007	Letter from counsel for petitioners proposing to lodge copies of record material of the cited case Bonaparte v. Tax Court, 104 U.S. 592 (1881).
Nov 5 2007	Argued. For petitioners: C. Christopher Trower, Atlanta, GA For respondents: G. Eric Brunstad, Jr., Hartford, Conn.
Nov 14 2007	Copies of record material of the cited case Bonaparte v. Tax Court, 104 U.S. 592 (1881) LODGED by petitioner at the request of the Clerk. (Distributed)

Supreme Court, U.S.
FILED

No. 06-

06-666 NOV 9 - 2006

IN THE OFFICE OF THE CLERK

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY and FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

versus

GEORGE W. DAVIS and CATHERINE V. DAVIS,
Respondents.

On Petition for a Writ of Certiorari to the Court of Appeals of Kentucky

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

PARTIES TO THE PROCEEDING

The Petitioners are the Department of Revenue and Finance and Administration of the Commonwealth of Kentucky.

The Respondents are George W. Davis and Catherine V. Davis.

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PETITION FOR A WRIT OF CERTIORARI

The Department of Revenue and Finance and Administration Cabinet of the Commonwealth of Kentucky respectfully petition this Court for a writ of certiorari to review the judgment rendered by the Kentucky Court of Appeals on January 6, 2006.

OPINIONS BELOW

The opinion of the Kentucky Court of Appeals is reported at 193 S.W.3d 557 (Ky. App. 2006). Pet. App. 1 - 13. The order of the Kentucky Supreme Court denying the Petitioner's motion for discretionary review of that opinion is unreported and is reprinted at Pet. App. 14. The order of the Jefferson Circuit Court that was reversed by the opinion of the Kentucky Court of Appeals is also unreported and is reprinted at Pet. App. 15 - 19.

STATEMENT OF JURISDICTION

The judgment of the Kentucky Court of Appeals was rendered on January 6, 2006. Pet. App. 1. The Petitioners timely filed a timely motion for discretionary review with the Kentucky Supreme Court on February 2, 2006, which was denied on August 17, 2006. Pet. App. 14. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Art. I, § 8, cl. 1 provides that "[t]he Congress shall have Power... To regulate commerce with foreign nations, and among the several States, and with the Indian tribes."

The relevant statutory and regulatory provisions – Ky. Rev. Stat. §§ 141.020 and 141.010 and 103 Ky. Admin. Regs. 17:060 – are reproduced at Pet. App. 20 - 23.

STATEMENT OF THE CASE

Kentucky law provides that "[a]n annual tax shall be paid for each taxable year by every resident individual of this state upon his entire net income as defined in this chapter." Ky. Rev. Stat. Ann. § 141.020(1). "The entire net income of a full-year resident individual is subject to Kentucky income tax regardless of its source" and "[i]ncome from out-of-state sources is not exempt." 103 Ky. Admin. Regs. 17:060 § 1. Persons who become Kentucky residents during the year and Kentucky residents who become nonresidents during the year are subject to Kentucky individual income tax upon their entire net income from any source while they are Kentucky residents. 103 Ky. Admin. Regs. § 17.060 §§ 2 (1) and 3(1). *See also* Ky. Rev. Stat. Ann. § 141.010(4), (6), and (7).[1]

"Net income" is defined in Ky. Rev. Stat Ann. § 141.010(11) as "adjusted gross income as defined in [Ky. Rev. Stat. Ann. § 141.010(10)]," minus various deductions further enumerated in Ky. Rev. Stat. Ann. § 141.010(11). Kentucky "[a]djusted gross income" is defined in Ky. Rev. Stat. Ann. § 141.010(10) as "gross income as defined in [Ky. Rev. Stat. Ann. § 141.010(9)], minus the deductions allowed individuals by section 62 of the Internal Revenue Code and as modified by [Ky. Rev. Stat. Ann. § 141.0101]" and adjusted further in Ky. Rev. Stat. Ann. § 141.010(10).

"Gross income" is defined in Ky. Rev. Stat. Ann. § 141.010(9) as " 'gross income' as defined in Section 61 of the Internal Revenue Code." Under Section 61 of the Internal

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[1] A nonresident individual, on the other hand, is subject to Kentucky income tax "only upon the amount of [net] income received by him from labor performed, business done, or from other activities in this state, from tangible property located in this state, and from intangible property which has acquired a business situs in this state." Ky. Rev. Stat. Ann. § 141.020(4). *See also* 103 Ky. Admin. Regs. 17:060 § 4.

Revenue Code, "interest received by or credited to the taxpayer constitutes gross income and is fully taxable." 26 C.F.R. § 1.61-7(a). This "[i]nterest income includes . . . interest on coupon bonds [and] interest on a corporate bond or debenture." *Id.* "[G]ross income does not include interest on any State or local bond" — i.e., any "obligation of a State or political subdivision thereof." 26 U.S.C. §§ 61(a), 103(a) and (c)(1); 26 C.F.R. § 1.61-7(b).[2]

Among the adjustments made to this federal gross income to arrive at Kentucky adjusted gross income is the inclusion or add-back of "interest income derived from obligations of sister states and political subdivisions thereof." Ky. Rev. Stat. Ann. § 141.010(10)(c). The effect of this provision is to provide an exemption from Kentucky income tax for interest income from bonds or obligations of the Commonwealth of Kentucky and its political subdivisions.[3]

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[2] Ky. Rev. Stat. Ann. § 141.050(1) states:

> Except to the extent required by differences between this chapter and its application and the federal income tax law and its application, the administrative and judicial interpretations of the federal income tax law, computations of gross income and deductions therefrom, accounting methods, and accounting procedures, for purposes of this chapter shall be as nearly as practicable identical with those required for federal income tax purposes.

[3] This exemption is reinforced by a number of statutory provisions that specifically exempt bonds of the Commonwealth from taxation. *See, e.g.*, Ky. Rev. Stat. Ann. § 164A.200 (Kentucky Higher Education Student Loan Corporation bonds); Ky. Rev. Stat. Ann. § 198.200 (Kentucky Housing Corporation bonds); Ky. Rev. Stat. Ann. § 224A.210 (revenue bonds or notes issued by the Kentucky Infrastructure Authority); Ky. Rev. Stat. Ann. § 154.20-035(12)(Kentucky Economic Development Finance Authority bonds and notes); Ky. Rev. Stat. Ann. § 56.514(3)(revenue bonds, notes and other obligations issued by State Property and Buildings Commission); Ky. Rev. Stat. Ann. § 56.869 (notes issued by the Kentucky Asset/Liability Commission).

The Respondents are "individual residents of Jefferson County, Commonwealth of Kentucky" who paid Kentucky income tax "on interest income derived from obligations of sister states and/or their political subdivisions." They brought this action for declaratory and injunctive relief and tax refunds in the Circuit Court of Jefferson County, Kentucky. The Respondents asserted that Kentucky's income tax violated the Commerce Clause by "discriminat[ing] on its face against the holders of obligations of sister states and/or their political subdivisions . . . by imposing a tax and corresponding burden on such interest income that is greater than that imposed on interest income derived from obligations of the Commonwealth of Kentucky and its political subdivisions." They also alleged that Kentucky's law violated the Equal Protection Clause and Sections 3 and 171 of the Kentucky Constitution, because "it does not tax in-state interest and out-of-state interest, otherwise similar in economic substance, at the same rate."

The Petitioners moved for summary judgment.[4] On August 30, 2004, the Jefferson Circuit Court granted the Petitioners' motion. Pet. App. 15 - 19. The court relied upon the market participant doctrine in ruling that Kentucky's law did not violate the Commerce Clause. Pet. App. 18 (*citing Reeves, Inc.* v. *Stake*, 447 U.S. 429 (1980) and *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794 (1976)). The court observed that "[w]hen a state issues municipal bonds, it participates in the bond market by supplying bonds in the market and paying interest on those bonds."

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[4] The Petitioner Department of Revenue is the department of the Petitioner Finance and Administration Cabinet that "exercise[s] all administrative functions of the [Commonwealth of Kentucky] in relation to the [Commonwealth's] revenue and tax laws." Ky. Stat. Ann. §§ 131.030(1); 12.020, II, 7; 42.012; 42.014.

Pet. App. 18. Finally, the circuit court found that Kentucky's law otherwise had "a reasonable, legitimate purpose" and was therefore constitutional. Pet. App. 19.

The Respondents appealed the circuit court's order granting the Petitioners' motion for summary judgment to the Kentucky Court of Appeals. On January 6, 2006, the Court of Appeals rendered an opinion vacating the circuit court's decision and remanding the case for further proceedings. Pet. App. 1, 13. The court held that "[c]learly, Kentucky's bond taxation system is facially unconstitutional [under the Commerce Clause] as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds."[5] Pet. App. 6. It found that "none of the arguments in favor of its constitutionality offered by the [Petitioners] or relied upon by the [circuit court] are sufficient to save it." Pet. App. 10. The Court of Appeals stated the following with respect to the market participant doctrine:

> The [Petitioners'] market participant argument is unavailing, however. No one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds. But Kentucky's issuance of bonds is not the issue. Rather, the sole issue is Kentucky's decision to tax only extraterritorial bonds. Thus, the market participant theory is inapplicable as a State's "assessment and computation of taxes" is, clearly, "a primeval governmental activity." Therefore, the [Petitioners'] market participant argument is without merit.

Pet. App. 10 (footnotes omitted).

Pursuant to Kentucky Civil Rule 76.20, the Petitioners timely filed a motion for discretionary review of the Court

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[5] The Court of Appeals did not reach the Respondents' other federal constitutional claim, stating that "[g]iven our Commerce Clause analysis, we also find it unnecessary to engage in an Equal Protection analysis." Pet. App. 11.

of Appeals' opinion with the Kentucky Supreme Court. On August 17, 2006, the Supreme Court denied the Petitioners' motion. Pet. App. 14.

REASONS FOR GRANTING THE WRIT

I. THIS CASE PRESENTS AN IMPORTANT QUESTION OF FEDERAL CONSTITUTIONAL LAW ON WHICH THE COURTS BELOW ARE DIVIDED.

This case presents a pure question of federal constitutional law not dependent on the presence or development of any particular facts. Relying upon the Commerce Clause, the Kentucky Court of Appeals held unconstitutional on its face a provision of Kentucky's income tax law that taxed the interest income from bonds issued by Kentucky's sister states and their political subdivisions, while not taxing interest income from bonds issued by Kentucky and its political subdivisions. Pet. App. 6.

This decision is squarely at odds with the decision of the Ohio Court of Appeals in *Shaper* v. *Tracy*, 97 Ohio App.3d 760, 647 N.E.2d 550 (1994), *motion to certify den.*, 71 Ohio St.3d 1477, 645 N.E.2d 1257 (1995), *cert. den.*, 516 U.S. 907 (1995). The court in *Shaper* upheld against Commerce Clause challenge a state income tax law indistinguishable from Kentucky's law. 647 N.E.2d at 552. The Ohio court found that "neither the Supreme Court nor any case law examined has applied the Commerce Clause to a case such as this, where one governmental entity is taxing its residents for the interest earned on bonds issued by another government entity." *Id.* at 552, 553. The Ohio Court of Appeals rejected the application of the market participant doctrine, although it recognized that "[e]ach state has a legitimate interest in tapping a major source of tax revenue while adding an incentive for investors to purchase state bonds" and that "[t]hose investors then become the major beneficiaries of the issuance of the bonds for

state issues, capital improvements and similar benefits." *Id.* at 552, 553 (internal quotation marks omitted). The Ohio court instead upheld its law based upon its conclusion "that the Commerce Clause was simply never intended to apply to acts of a sovereign on behalf *of itself* where the end result is to provide the taxing state with a competitive advantage over *another* sovereign." *Id.* at 552, 553-54 (emphasis by court).

The significance of this issue runs both broad and deep. First, the issue affects the overwhelming majority of the states. Kentucky and Ohio are two of thirty-eight states whose income tax laws subject interest earned on bonds issued by other states and their political subdivisions to taxation while exempting interest earned on their own bonds.[6] *The Bond Buyer/Thomson Financial 2006 Yearbook at* 102-03 (Source Media 2006). Another four states

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[6] Ala.Code § 40-18-14(3)f (2003); Ariz. Rev. Stat Ann. § 43-1021(3) (West 2006); Ark.Code Ann. § 26.51-404(b)(5) (Michie 2005); Cal. Rev. & Tax Code § 17133 (West 2004); Colo Rev. Stat. § 39-22-104(3)(b); Conn. Gen. Stat. § 12-505(a)(4)(B)(West 2000); Del. Code. Ann. tit. 30, § 1106(a)(1)a. (1997); Ga. Code. Ann. § 48-7-27(b)(1)(A)(Michie 2005); Haw. Rev. Stat. § 235-7(a)(5), (b)(2)(2002); Idaho Code § 63-3022 M(1) and (3)(b) (2000); Kan. Stat. Ann. § 79-32, 117(b)(i)(1997); La. Rev. Stat. Ann. § 47.293(6)(a)(West 2001); Me Rev. Stat. Ann., tit. 36 § 5122 (A)(West 2005); Md. Code Ann., Tax-Gen. §§ 10-203 and 10-204 (a) and (b)(2004); Mass. Gen. Laws. Ann. Ch. 62, § 2(a)(1)(A)(2001); Mich. Comp. Laws § 206 30 (1)(a)(West 2003); Minn. Stat. Ann. § 290.01 (19a)(1) (1)(West 1999); Miss. Code Ann. § 27-7-15(4)(d)(West 2006); Mo. Rev. Stat. § 143.121(2)(b)(West 2006); Mont. Code Ann. § 15-30-111(1)(a)(2005); Neb. Rev. Stat. § 77-2716(1)(c)(2003); N.H. Rev. Stat. Ann. § 77.4(I)(2001); N.J. Rev. Stat. § 54A: 6-14 (West 2002); N.M. Stat. Ann. § 7-2-2(B)(3) and (V)(2001); N.Y. Tax Law § 612(b)(1) (West 1999); N.C. Gen. Stat. § 105-134.6 (c) (1)(2005); N.D. Cent. Code § 57-38-01.2(1)(g)(2005); Ohio Rev. Code Ann. §

(Continued next page)

exempt interest earned on some bonds issued by them or their political subdivisions while taxing interest earned on all bonds issued by other states and their political subdivisions. *Id.*[7] *See also* Scott K. Attaway, Note, *The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds* 76 B.U.L. Rev. 737, 738, n. 4 (1996).

Second, states and local governments rely heavily upon the issuance of debt to finance public projects. Justice O'Connor in her dissent in *South Carolina* v. *Baker*, 485 U.S. 505 (1988) observed:

> Long-term debt obligations are an essential source of funding for state and local governments. In 1974, state and local governments issued approximately $23 billion of new municipal bonds; in 1984, they issued $102 billion of new bonds. Report of Special Master 20. State and local governments rely heavily on borrowed funds to finance education, road construction, and utilities, among other purposes. As the Court recognizes, States will have to increase the interest rates they pay on bonds by 28-35% if the interest is subject to the federal income tax. *Ante*, at 511. Gov-

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(Continued from preceding page)

5747.01 (A)(1)(West 2002); Okla Stat. Ann. tit. 68, § 2358(A)(1)(West 2002); Or. Rev. Stat. § 316.680(2)(a)(2005); 72 Pa. Cons. Stat. Ann. § 7302 and 7303(a)(3) and (6)(West 2000); R.I. Gen. Laws § 44-30-12(a) and (b)(1)(2005); S.C. Code Ann. § 12-6-1120(1)(West 2000); Tenn. Code Ann. § 67-2-104(e)(2003); Vt. Stat. Ann. tit. 32, § 5811(18)(A)(i)(II)(2005); Va. Code Ann. § 58.1-322 (B)(1)(2004); W. Va. Code § 11-21-12(b)(1)(2005).

[7] One state (Utah) exempts its own bonds and those out-of-state bonds purchased after January 1, 2003 from issuers in states that do not tax interest income received from Utah bonds. *Id.* One state (Indiana) exempts all interest on bonds issued by states and their political subdivisions. *Id.* Six states do not impose an income tax. *Id.*

> ernmental operations will be hindered severely if the cost of capital rises by one-third. If Congress may tax the interest paid on state and local bonds, it may strike at the very heart of state and local government activities.

Id. at 531-32. A recent publication of the Statistics of Income Division of the Internal Revenue Service reports:

> State and local governmental units issued nearly $2.1 trillion of tax-exempt bonds between 1996 and 2002. The majority ($1.5 trillion) of these tax-exempt bonds were Governmental bonds, the proceeds of which helped finance public projects (such as schools, streets, and utilities). The balance, $0.5 trillion, comprised private activity bonds, the proceeds of which were used for qualified facilities (such as airports, docks and wharves, and solid waste disposal facilities), as well as to benefit Internal Revenue Code section 501(c)(3) organizations (such as hospitals and private universities).

Cynthia Belmonte, *Tax-Exempt Bonds, 1996-2002*, at 151 (SOI Bulletin Summer 2005), available at http://www.irs.gov/pub/irs-soi/02govbnd.pdf.

Credit is of course a matter of vital importance to state and local governments. As the Georgia Supreme Court noted almost a century ago:

> The government, whether it be the state or one of its political subdivisions, is dependent, for the due exercise of its powers, on certain instrumentalities needful and proper in the matter with which it is dealing. Credit is absolutely indispensable to any government, whether it exists in the form of a state government or in the form of the government of one of the political subdivisions of the state. It becomes necessary, in the life of a state, as well as of its political subdivisions, to be able to establish credit in order to carry on successfully and properly the governmental functions. One of the most usual and ordinary methods of using the

> credit of a government is by the issue of securities and placing them in the markets of the world for sale.

Penick v. *Foster*, 129 Ga. 217, 58 S.E. 773, 775 (1907). The importance of credit extends to all levels of government. For 2002, "[a]lmost 50 percent of the total number of new money long-term Governmental bond issues were for small bonds with an issue price of less than $1 million." Belmonte, *supra* at 154. These bonds "were generally issued by smaller towns for purposes such as school buses, fire trucks, and other unspecified expenditures." *Id.*

Tax exemptions such as the one at issue in this case facilitate the vital function of borrowing by governments. Their role has been described as follows:

> If [outstanding public bonds] are held to be taxable, the inevitable result will be that the rate of interest is increased. If the rate of interest is increased, additional taxes would be required to pay it. No practical benefit would be derived. The operation of local government would be hampered and impeded and the funds and property of the issuing body materially affected.

In re Droll, 108 Neb. 85, 187 N.W. 876, 878 (1922). This point was echoed in *Fidelity Guarantee Mortgage Corp.* v. *Connecticut Housing Authority*, 532 F.Supp. 81 (D.Conn. 1982):

> The Connecticut Housing Finance Authority, ("CHFA"), was established by the Connecticut General Assembly in 1969 in order to alleviate the shortage of housing for low and middle income families and to encourage those families to settle in designated urban areas within the State. To achieve this end, CHFA is empowered to issue bonds the proceeds of which are made available as mortgage loans to qualified families. Because CHFA is a political subdivision of the State, the interest paid to bondholders on the bonds is tax exempt under provisions of the Internal Revenue Code.

> CHFA is thus able to offer the bonds at lower interest rates than would have to be paid by a private entity. This, in turn, enables CHFA to charge lower rates of interest on the mortgage loans to qualified borrowers.

Id. at 82 (footnotes omitted). *See also* Belmonte, *supra* at 151 (noting that tax exemption for state and local bond interest "effectively lowers the borrowing cost of tax exempt debt issuers, since bondholders are generally willing to accept an interest rate lower than that earned on comparable taxable bonds").

The decision of the Kentucky Court of Appeals, if allowed to stand, creates considerable uncertainty for a significant number of states and their political subdivisions in this critical area of public finance. State and local governments will not know for sure whether one of their costs of borrowing money will include providing "meaningful backward-looking relief" — tax refunds or the collection of back taxes from the impermissibly favored taxpayers — if their courts agree with the Kentucky Court of Appeals. *McKesson* v. *Division of Alcoholic Beverages and Tobacco, Department of Business Regulation of Florida*, 496 U.S. 18, 31, 39-41 (1990). They would also risk the complete loss of the ability to exempt their bonds or the interest therefrom if their courts opted for that approach as a prospective remedy. *Davis* v. *Michigan Dept. of Treasury*, 489 U.S. 803, 817-18 (1989)(stating that "[w]e have recognized, in cases involving invalid classifications in the distribution of government benefits, that the appropriate remedy is a mandate of equal treatment, a result that can be accomplished by withdrawal of benefits from the favored class as well as by extension of benefits to the excluded class' " and holding that the state courts were "in the best position to de-

termine how to comply with the mandate of equal treatment").[8]

Under the Kentucky court's decisions, state and local governments will lose an important advantage in a limited market — their taxpayers — on which they rely as a source of funds raised through borrowing. Tax exemptions such as that at issue in this case allow state and local governments to pay less interest and offset advantages that bonds of other jurisdictions with higher credit ratings enjoy. *See* Robert Zipf, *How the Bond Market Works*, at 54 (2nd ed. 1997). The tax exemption influences a Kentucky resident to choose to acquire a bond issued by Kentucky or a Kentucky municipality over a bond issued by another state or other state's municipality that pays a higher rate of interest or has a stronger credit rating. If the Kentucky court's decision stands, state and local governments will lose this important edge in seeking to borrow from their taxpayers for the benefit of their respective constituencies.

Therefore, the practice held invalid by the Kentucky Court of Appeals is one that is not only widespread among the states, but one that is one of great ongoing importance to the funding of public projects. The issue presented by this case will therefore certainly arise again. If this issue is not addressed now, the dormant Commerce Clause will not only mean one thing in Kentucky and quite another in Ohio, but there will be considerable doubt and uncertainty as to the validity of a practice engaged in by the great majority of states. This is also a practice which the states

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[8] Similarly, prospective purchasers and holders of these bonds would face the risk of efforts to collect back taxes in the event of a state court's adherence to the Kentucky court's decision. *McKesson*, 496 U.S. at 39-41. They would also face the risk of losing the state tax exemption prospectively if a state court held that to be the appropriate remedy. *Davis*, 489 U.S. at 817-18.

substantially rely "to raise capital for essential public facilities, infrastructure, and general capital improvements." Belmonte, *supra* at 151.

The potential ramifications of the decision below therefore consist of the crippling, and possibly the demise, of a practice of great importance to the states and their taxpayers, particularly those who provide the very capital to fund needed infrastructure and other public purposes.[9] It is a practice that enables the states to raise needed funds and serve their citizens at less cost. This Court should address this issue now to eliminate the uncertainty as to the validity of this salutary practice.

I. THE DECISION BELOW IS AT ODDS WITH PRIOR DECISIONS OF THIS COURT AND PRESENTS AN IMPORTANT CONSTITUTIONAL QUESTION THAT SHOULD BE SETTLED BY THIS COURT

This Court has admonished that under the dormant Commerce Clause, "the result turns on the unique charac-

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[9] The significance of this case extends beyond its particular context. For example, the Kentucky court's decision in this case calls into question tax exemptions for property owned by a taxing state but not property owned by other states. *See, e.g., State* v. *City of Hudson*, 231 Minn. 127, 42 N.W.2d 546, 549 (1950); *State ex rel. Taggart* v. *Holcomb*, 85 Kan. 178, 116 P. 251, 253 (1911); *City of Cincinnati* v. *Commonwealth*, 292 Ky. 597, 167 S.W.2d 709, 714-15 (1942); *Warren County* v. *Hester*, 219 La. 763, 54 So.2d 12 (1951). The rationale behind tax exemptions for property of a state and its municipalities is that in the absence of such an exemption, the public would be taxing itself to raise money to pay itself. *See, e.g., Van Buren Hospital and Clinics* v. *Board of Review of Van Buren County*, 650 N.W.2d 580, 586-87 (Iowa 2002). Under the Kentucky court's decision in this case, one could argue that a state must treat property within its jurisdiction that is owned by another state in the same manner for tax purposes as its own property — despite the obvious absence of the public policy justification for the exemption.

teristics of the statute at issue and the particular circumstances in each case." *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318, 329 (1977). *See also Freeman* v. *Hewitt*, 329 U.S. 249, 252 (1946) ("Suffice it to say that especially in this field opinions must be read in the setting of the particular cases and as the product of preoccupation with their special facts"). The decision below failed to heed this admonition.

None of the decisions relied upon by the Kentucky Court of Appeals addressed facts even remotely similar to those presented by this case. Discrimination against interstate commerce in the contexts of those cases consisted of "economic protectionism – that is, 'regulatory measures designed to benefit in-state *economic interests* by burdening out-of-state *competitors*.' " *Associated Industries of Missouri, Inc.* v. *Lohman*, 511 U.S. 641, 647 (1994)(emphasis added). In *Oklahoma Tax Commission* v. *Jefferson Lines, Inc.*, 514 U.S. 175 (1995), this impermissible discrimination against interstate commerce was described as follows:

> A state may not "impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to *local business*." . . . Thus, States are barred from discriminating against *foreign enterprises* competing with *local businesses* . . . and from discriminating against *commercial* activity occurring outside the taxing State . . .

Id. at 197 (emphasis added)(citations omitted). Such is not the case here. Instead, what is at issue in this case is not a tax law that "benefit[s] a private industry or business in the state, to the detriment of out-of-state businesses," but one where a sovereign is acting on its own behalf in the service of its citizens in a manner that favors itself over other sovereign states. *Shaper*, 647 N.E.2d at 552.

The states are not mere economic interests or business enterprises, but sovereigns that function as such. *Alden* v.

Maine, 527 U.S. 706, 713-715 (1999); *New York* v. *United States*, 505 U.S. 144, 162-63, 188 (1992). This Court has fashioned the market participant doctrine, recognizing that "nothing in the purpose animating the Commerce Clause prohibits a State, in the absence of congressional action, from participating in the market *and exercising the right to favor its own citizens over others.*" *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794, 810 (1976)(footnotes omitted)(emphasis added). This Court has further stated that:

> [t]he Commerce Clause responds principally to state taxes and regulatory measures impeding *free private trade* in the national marketplace . . . There is no indication of a constitutional plan to limit the ability of the States themselves to operate freely in the free market.

Reeves, Inc. v. *Stake*, 447 U.S. 429, 436-37 (1980)(emphasis added)(citations omitted).

"Restraint in this area," this Court stated in *Reeves*, is "counseled by considerations of state sovereignty, the role of each state as guardian and trustee for its people." *Id.* at 438 (internal quotation marks omitted). In rejecting a claim of economic protectionism in violation of the Commerce Clause, this Court further explained:

> We find the label "protectionism" of little help in this context. The State's refusal to sell to buyers other than South Dakotans is "protectionist" only in the sense that it limits benefits generated by a state program to those who fund the state treasury and who the State was created to serve. Petitioner's argument apparently also would characterize as "protectionist" rules restricting to state residents the enjoyment of state educational institutions, energy generated by a state-run plant, police and fire protection, and agricultural improvement and business development programs. Such policies, while perhaps "protectionist" in

> a loose sense, reflect the essential and patently unobjectionable purpose of state government — to serve the citizens of the State.

Id. at 442.

As we have seen *supra*, the purpose of the tax exemption in question is to facilitate government borrowing by making it less costly for the government to enter the capital market. The purpose of a state's entry into the market is to raise needed funding for government purposes and public projects. The tax exemption is an inducement to persons subject to the state's income tax law — primarily its residents — to loan the state needed funds. It makes bonds of Kentucky and its political subdivisions competitive in this limited market with corporate bonds and bonds of other states and their political subdivisions that pay higher rates of interest or that have better credit ratings.

Therefore, this is a case of a state participating in a market in such a manner as to favor its interests and citizens over others. *Hughes*, 426 U.S. at 809-10. The State is inducing its citizens (or those persons otherwise subject to its tax laws) to loan it money to finance public purposes and projects that benefit and serve those citizens. *See, e.g.*, Belmonte, *supra* at 151 ("A bond is an interest-bearing security of indebtedness, i.e., an obligation by the issuer to repay a certain sum of money by a future date, with interest payable at a specified rate"). The tax exemption is essential to the state's marketing of its bonds to its residents, a "discrete, identifiable class of economic activity in which the [state and its political subdivisions are] major participant[s]." *White* v. *Massachusetts Council of Construction Employers, Inc.*, 460 U.S. 204, 211, n. 7 (1983)(holding that dormant Commerce Clause was not violated by a city executive order requiring all construction projects funded in whole or in part by the city or by city funds to be performed by a work force consisting of at least half bona fide residents of the city).

The Kentucky Court of Appeals relied upon *New Energy Company of Indiana* v. *Limbach*, 486 U.S. 269 (1988) in rejecting the application of the market participant doctrine to this case. Pet. App. 10. The linchpin of its holding was the following passage from that opinion:

> The market-participant doctrine has no application here. The Ohio action ultimately at issue is neither its purchase nor its sale of ethanol, but its assessment and computation of taxes – a primeval governmental activity.

Id. at 277. This language must be read in light of the facts before the Court in that case, *see Boston Stock Exchange*, 429 U.S. at 329; *Freeman* v. *Hewitt*, 329 U.S. at 252, which consisted of the effect of a tax credit scheme upon *private* purchases and sales of ethanol. The Petitioners submit that the Kentucky action ultimately at issue in this case is Kentucky's participation in a limited segment of the bond market. The tax exemption at issue is part and parcel of that market participation and in this context is not simply a "primeval governmental activity."

The application of the market participant doctrine by the Kentucky Court of Appeals therefore conflicts with prior decisions of this Court. The meaning of the passage from *New Energy* relied upon by the Kentucky court is a matter that can only be settled by this Court.

The decision of the Kentucky Court of Appeals is also at odds with this Court's decision in *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881). At issue in that case was "whether the registered public debt of one State, exempt from taxation by the debtor State, or actually taxed there, is taxable by another State when owned by a resident of the latter State." 104 U.S. at 594. This Court held that "[w]e know of no provision of the Constitution of the United States which prohibits such taxation." Id. It reasoned:

> It is true, if a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced interest; but, inasmuch as it cannot secure such exemption outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals. While the Constitution of the United States might have been so framed as to afford relief against such a disability, it has not been, and the States are left free to extend the comity which is sought, or not, as they please.

Id. at 595. This reasoning is consistent with that of the later case of *Georgia* v. *Chattanooga*, 264 U.S. 472 (1924):

> Land acquired by one State in another State is held subject to the laws of the latter and to all the incidents of private ownership. The proprietary right of the owning state does not restrict or modify the power of eminent domain of the state wherein the land is situated . . . The sovereignty of Georgia was not extended into Tennessee. Its enterprise in Tennessee is a private undertaking. It occupies the same position there as does a private corporation authorized to own and operate a railroad, and, as to that property, it cannot claim sovereign privilege or immunity.

Id. at 480-81 (citations omitted). *See also Nevada* v. *Hall*, 440 U.S. 410, 424-27 (1979) (holding that sovereign immunity of one state is not required to be honored by courts of another state).

The Kentucky Court of Appeals dismissed *Bonaparte* as inapplicable because the challenge there was premised upon the Full Faith and Credit Clause (Art. IV, § 1). Pet. App. 9. The *Bonaparte* Court's reasoning which formed the basis of its holding was not so narrow, however. It expressly stated that "*no provision* of the Constitution . . . prohibit[ed] such taxation," id. at 594 (emphasis added), and that a State outside of its own jurisdiction "must go

into the market as a borrower, subject to the same disabilities in this particular as individuals." *Id.* at 595.

The decision of the Kentucky court conflicts with *Bonaparte*. Kentucky's law treats bonds of other states and their political subdivisions in the same manner as bonds issued by private issuers. The Kentucky Court of Appeals held that this was not enough; that instead Kentucky must effectively allow other states' sovereignty to cross state lines into Kentucky, thereby entitling those states' bonds to the same legal stature as bonds issued by Kentucky. This is squarely at odds with the conception of the extent of a state's sovereignty expressed in *Bonaparte* and later cases, as well as the holding of *Bonaparte* that any favorable tax treatment of another state's bonds was strictly a matter of comity on the part of the taxing state.

Perhaps viewed another way, the Kentucky court's decision overlooks the threshold Commerce Clause principle that "any notion of discrimination assumes a comparison of substantially similar entities." *General Motors Corp.* v. *Tracy*, 519 U.S. 278, 298-99 (1997). *See also Kraft General Foods, Inc.* v. *Iowa Dept. of Revenue*, 505 U.S. 71, 80, n. 23 (1992). With respect to Kentucky's taxing jurisdiction, other states and their political subdivisions are not similarly situated to Kentucky and its political subdivisions. Those other states do not come into the Kentucky market as sovereigns but instead as private entities. *Bonaparte*, 104 U.S. at 595.

Finally, the view of the dormant Commerce adopted by the Court below commandeers Kentucky's tax laws to subsidize other states' public debt if it wishes to exempt its own debt from taxation. In *New York* v. *United States*, the Court stated that "[i]n providing for a stronger central government, the Framers explicitly chose a Constitution that confers upon Congress the power to regulate individuals, not States." 505 U.S. at 166. "The allocation of power

contained in the Commerce Clause, for example, authorizes Congress to regulate interstate commerce directly; it does not authorize Congress to regulate state governments' regulation of interstate commerce." *Id.* The Kentucky Court of Appeals' decision *mandates* what should instead be a matter of comity and is inconsistent with the Constitution's Tenth Amendment.

Therefore, the decision of the Kentucky Court of Appeals is contrary to prior decisions of this Court. It presents a pure question of law — the meaning and scope of the Constitution's dormant Commerce Clause — whose determination is dependent solely upon an analysis of this Court's precedents. Thus, it is an issue that can only be settled by this Court and one whose resolution cannot be aided by further consideration by lower courts.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

RENDERED: JANUARY 6, 2006; 10:00 A.M.
TO BE PUBLISHED

COMMONWEALTH OF KENTUCKY
COURT OF APPEALS
NO. 2004-CA-001940-MR

GEORGE W. DAVIS and
CATHERINE V. DAVIS - - - - - - *Appellants*

v.

DEPARTMENT OF REVENUE OF THE FINANCE AND ADMINISTRATION CABINET, COMMONWEALTH OF KENTUCKY (FORMERLY COMMONWEALTH OF KENTUCKY, REVENUE CABINET) AND COMMONWEALTH OF KENTUCKY FINANCE AND ADMINISTRATION CABINET - - - - - - - - - - *Appellees*

OPINION VACATING AND REMANDING

BEFORE: BARBER, MINTON, AND TAYLOR, JUDGES.
MINTON, JUDGE:

I. INTRODUCTION.

George and Catherine Davis appeal from the Jefferson Circuit Court's grant of summary judgment in favor of the Department of Revenue of the Finance and Administration Cabinet for the Commonwealth of Kentucky ("the Department"). Because we find that Kentucky's tax on the income derived from bonds issued outside Kentucky violates the Commerce Clause of the United States Constitution, we vacate, and remand.

II. FACTUAL BACKGROUND AND PROCEDURAL HISTORY.

Although the legal theories involved are quite complex,[1] the pertinent facts of this case are simple. Kentucky Revised Statute (KRS) 141.020 governs individual state income taxes. Similar provisions exist for the Commonwealth to tax estates, trusts, and fiduciaries,[2] as well as corporations.[3] KRS 141.020 requires an individual to pay state taxes upon a percentage of that person's net income.[4] For individuals, net income is determined by making certain deductions from the individual's adjusted gross income.[5] In turn, an individual's adjusted gross income is derived by making certain deductions from a person's gross income "as defined in Section 61 of the Internal Revenue Code."[6] In arriving at its definition of gross income, the Internal Revenue Code specifically exempts interest earned on any state or local bond.[7] But Kentucky law requires that "interest income derived from obligations of sister states and

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[1] Indeed, even the United States Supreme Court once declared its own jurisprudence involving the dormant Commerce Clause to be a "quagmire" which left "much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation." Northwestern States Portland Cement Co. v. State of Minn., 358 U.S. 450, 457-458 (1959).

[2] KRS 141.030.

[3] KRS 141.040.

[4] KRS 141.020(1); KRS 141.030(1); KRS 141.040(1).

[5] KRS 141.010(11) provides that "'[n]et income' in the case of taxpayers other than corporations means adjusted gross income as defined in subsection (10) of this section, minus the standard deduction allowed by KRS 141.081, or, at the option of the taxpayer, minus the deduction allowed by KRS 141.0202 . . . ."

[6] KRS 141.010(9), (10). Section 61 of the Internal Revenue Code is codified at 26 U.S.C. § 61.

[7] 26 U.S.C. § 103 provides that "gross income does not include interest on any State or local bond."

political subdivisions thereof" is to be included in a person's adjusted gross income.[8] The cumulative impact of those various statutes is that Kentucky exempts from taxation interest income derived from bonds issued by the Commonwealth of Kentucky or its subdivisions but requires taxes to be paid on interest income derived from bonds issued by a sister state or its subdivisions.

In April 2003, the Davises filed a class action declaratory judgment complaint alleging that Kentucky's decision to tax the income earned on out-of-state bonds in this manner violates the Commerce Clause of the United States Conmstitution and the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. To attempt to demonstrate standing, the Davises alleged in their complaint that they were residents of Jefferson County who had paid Kentucky income tax on the income they earned from out-of-state bonds.

In July 2003, before the Davises had filed a motion for class certification, the Department filed a motion for summary judgment arguing that the tax system in issue was constitutional and that, furthermore, the Davises lacked standing to challenge the tax provisions applicable to corporations, estates, and trusts. In August 2004, the Jefferson Circuit Court granted the Department's motion for summary judgment on both the constitutionality of the bond taxation system and the question of the Davises' standing. The Davises filed this appeal.

III. ANALYSIS.

The Davises' appeal presents two issues. First, did the trial court correctly grant summary judgment to the Department on the Davises' claim that Kentucky's system of taxing only out-of-state bonds is unconstitutional? Second, did the trial court correctly find that the Davises lacked standing to assert claims on behalf of corporations, trusts,

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[8] KRS 141.010(10) (c). Similarly, "interest income derived from obligations of sister states and political subdivisions thereof" is included in a corporation's gross income. KRS 141.010(12)(c).

estates, and all other non-individual plaintiffs? Following a recitation of the applicable standards of review, each question will be addressed separately.

A. Standard of Review.

Summary judgment is appropriate only if the Department showed that the Davises "could not prevail under any circumstances."[9] In ruling on a motion for summary judgment, we must view the evidence in the light most favorable to the Davises.[10] An appellate court reviewing a grant of summary judgment must determine whether the trial court correctly found that there were no genuine issues of material fact.[11] As findings of fact are not at issue, the trial court's decision is entitled to no deference.[12]

B. Constitutionality of Kentucky's Taxation System.

"The test of the constitutionality of a statute is whether it is unreasonable or arbitrary."[13] A statute is constitutionally valid "if a reasonable, legitimate public purpose for it exists, whether or not we agree with its' 'wisdom or expediency.' "[14] The Davises' burden is heavy as "[a] strong presumption exists in favor of the constitutionality of a statute."[15]

Bearing these principles in mind, we now turn our attention to the Davises' contention that Kentucky's system of taxing only extraterritorial bonds violates the Commerce

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[9] Steelvest, Inc. v. Scansteel Service Center, Inc., 807 S.W.2d 476, 480 (Ky. 1991) (citing Paintsville Hosp. Co. v. Rose, 683 S.W.2d 255 (Ky. 1985)).

[10] *Id.*

[11] Scifres v. Kraft, 916 S.W.2d 779, 781 (Ky. App. 1996).

[12] *Id.*

10 Buford v. Commonwealth, 942 S.W.2d 909, 911 (Ky. App. 1997).

[14] *Id.* (quoting Walters v. Bindner, 435 S.W.2d 464, 467 (Ky. 1968).

[15] *Id.*

Clause of the United States Constitution.[16] This issue is a matter of first impression in Kentucky.[17]

The Commerce Clause simply provides that Congress has the power to "regulate Commerce with foreign Nations, and among the several States[.]"[18] But despite the fact that the Commerce Clause "is phrased merely as a grant of authority to Congress to 'regulate Commerce . . . among the several States,' Art. I, § 8, cl. 3, it is well established that the Clause also embodies a negative command forbidding the States to discriminate against interstate trade."[19] This "negative" or dormant aspect of the Commerce clause "prohibits economic protectionism-that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors."[20] Thus,

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[16] We note that we have the authority to resolve this dispute even though it revolves entirely around interpreting the United States Constitution. *See* Boston Stock Exchange v. State Tax Commission, 429 U.S. 318, 320-321 (1977) ("We agree, of course, that state courts of general jurisdiction have the power to decide cases involving federal constitutional rights where, as here, neither the Constitution nor statute withdraws such jurisdiction'.")

[17] Both the Davises and the Departinent cite other cases in support of their positions. However, with the exception of a case from Ohio (which will be discussed at length *infra),* none of the cited cases are of much significance or help because they are not factually nor legally on all fours with this action. *See,* e.g., Scott K. Attaway, Note, The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds, 76 B.U. L. Rev. 737, 769 (1996) ("State tax exemption of income earned by residents in transacting with the state does not fall neatly within any of the Supreme Court's established Commerce Clause doctrines."). Therefore, we will not belabor this opinion by specifically distinguishing each case cited to us as the statement of points and authorities in the parties' briefs total thirteen pages.

[18] U.S. Const., Art. I, § 8, cl. 3.

[19] Associated Industries of Missouri v. Lohman, 511 U.S. 641, 646 (1994).

[20] New Energy Co. of Indiana v. Limbach, 486 U.S. 269, 273 (1988).

the "fundamental command"[21] of the Commerce Clause is that "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State."[22] As a result, "[s]tate laws discriminating against interstate commerce on their face are 'virtually *per se* invalid.' "[23]

Clearly, Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds.[24] Thus, Kentucky's bond taxation system may be found to be constitutionally valid only if it falls within an exception to the normal rule requiring laws that violate the Commerce Clause on their face to be stricken.[25] So we must evaluate the Department's three main arguments in support of Kentucky's taxation system to determine if the Department has met its burden to show

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[21] Lohman, 511 U.S. at 647.

[22] Armco Inc. v. Hardesty, 467 U.S. 638, 642 (1984).

[23] Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996).

[24] Even an author who believes that the separate tax status of in-state and out-of-state ,bonds should be constitutionally permissible agrees that a bond taxation system like Kentucky's is facially unconstitutional. *See* Attaway, 76 B.U. L. Rev. at 739 (1996) ("If subjected to traditional Commerce Clause scrutiny, such discriminatory tax treatment [of bonds] would surely fall under a 'virtually per se rule of invalidity.' ") (quoting Philadelphia v. New Jersey, 437 U.S. 617, 624 (1978)).

[25] Limbach, 486 U.S. at 274 ("Thus, state statutes that clearly discriminate against interstate commerce are routinely struck down, unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism.") (internal citations omitted).

that the taxation system in question is constitutionally permissible.[26]

First, one of the Department's main arguments in favor of Kentucky's taxation system is the fact that a similar system has been held to be constitutionally permissible in Ohio. In fact, despite the discriminatory bond taxing system's widespread use and obvious Commerce Clause implications,[27] apparently, only the Ohio courts have been presented with a case challenging it on Commerce Clause grounds.[28] The Ohio Court of Appeals ultimately concluded in Shaper that the bond taxation system was constitutionally permissible. But that court failed fully to analyze the issue. Shaper, though containing a well-written preliminary analysis of the Commerce Clause implications of this discriminatory bond taxing system, "made no attempt to explain why . . . a tax exemption that discriminates against income earned from out-of-state bonds . . . is permissible under the Commerce Clause."[29] Rather, the Shaper court

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[26] C & A Carbone, Inc. v. Town of Clarkstown, N.Y., 511 U.S. 383, 392 (1994) ("Discrimination against interstate commerce in favor of local business or investment is *per se* invalid, save in a narrow class of cases in which the municipality can demonstrate, under rigorous scrutiny, that it has no other means to advance a legitimate local interest."). *See also* Hughes v. Oklahoma, 441 U.S. 322, 337 (1979) (holding that the Court would apply the "strictest scrutiny" to determine if a statute which violates the Commerce Clause on its face was, nevertheless, permissible based upon the State's arguments); Limbach, 486 U.S. at 278-279 (discussing the state's high burden in showing that a statute which violates the Commerce Clause on its face is not invalid because there was no reasonable nondiscriminatory alternative)

[27] At the time Mr. Attaway's law review note was published, at least thirty-seven states had bond taxation systems similar to Kentucky's. *See* 76 B.U. L. Rev. at 738.

[28] Shaper v. Tracy, 647 N.E.2d 550 (Ohio Ct. App. 1994).

[29] 76 B.U. L. Rev. 738, n.6.

"tersely stat [ed] ' in effect, that 'we looked and did not find anything so therefore it must be constitutional.' "[30] Logic dictates, however, that a potentially problematic and constitutionally infirm statute does not become permissible simply because it has not been previously found to be unconstitutional. Rather, a court faced with a direct constitutional challenge to a statute must engage in a searching inquiry to determine whether a challenged statute can pass constitutional muster.[31] Thus, Shaper, though instructive in certain areas, is, in and of itself, insufficient to support the Department's position, meaning that we must examine the Department's other two main arguments.

The Department next argues that the bond taxation system must be found to be constitutional under the Supreme Court's holding in Bonaparte v. Tax Court.[32] In Bonaparte, a taxpayer contended that her state of residence was required by the Full Faith and Credit Clause of the United States Constitution[33] to exempt out-of-state

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[30] *Id.* Mr. Attaway's critique of Shaper is correct because the Shaper court, after examining various theories and inapplicable cases, simply stated its conclusion as follows: "Given the lack of any precedent to apply the Commerce Clause to this type of taxation scheme, we are unable to find R.C. 5747.01 [the Ohio statute in question] unconstitutional as violative of the Commerce Clause." Shaper, 647 N.E.2d at 553-554.

[31] Faced with a similar Commerce Clause challenge to a Kentucky system that taxed out-of-state bank deposits at a higher rate than in-state deposits, the Kentucky Supreme Court opined that a court could not shirk its duty fully to apply the law. Rather, a reviewing court "must enforce constitutional limitations." St. Ledger v. Commonwealth, 912 S.W.2d 34, 39 (Ky. 1995), vacated on other grounds by St. Ledger v. Kentucky Revenue Cabinet, 517 U.S. 1206 (1996).

[32] 104 U.S. 592 (1881).

[33] Article IV, Section 1 of the United States Constitution provides in relevant part that "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State."

bonds from taxation because the issuing state exempted them. The Supreme Court rejected the taxpayer's argument, holding that "no provision of the Constitution of the United States . . . prohibit [ed] such taxation."[34] However, Bonaparte is ultimately of little value to the case at hand because the Commerce Clause played no role in the Bonaparte court's decision.[35] As the case at hand involves a direct challenge under the dormant Commerce Clause and has nothing to do with the Full Faith and Credit Clause, it logically follows that Bonaparte is neither on point nor controlling.

Finally, the Department relies upon the market participant doctrine to save Kentucky's bond taxation system. The market participant theory "recognizes that when a sovereign acts as a consumer or vendor in commerce, its actions as a market participant are distinct from its actions as a market regulator. The Commerce Clause is directed at the state's actions as a market regulator; therefore, [a State's] actions as a market participant are exempted from Commerce Clause analysis."[36] Stated differently, the market participant theory "differentiates between a State's acting in its distinctive governmental capacity, and a State's acting in the more general capacity of a market participant; only the former is subject to the limitations of the negative Commerce Clause. Thus, for exanple,

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[34] *Id.* at 104 U.S. 594.

[35] *See,* e.g., Donald H. Regan, Siamese Essays: (I) CTS Corp. v. Dynamics Corp of America and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation, 85 Mich. L. Rev. 1865, 1887-1888 (1987) ("The Court in Bonaparte cites no constitutional provision in support of its claim that states cannot legislate extraterritorially. And quite properly not, since the extraterritoriality principle is not to be localized in any single clause. In particular, it is clear that the extraterritoriality principle as it appears in Bon. parte is not based on the commerce clause."); Shaper, 647 N.E.2d at 765 (discussing Bonaparte's holding and noting that it was not based on the commerce Clause).

[36] Shaper, 647 N.E.2d at 763.

when a State chooses to manufacture and sell cement, its business methods, including those that favor its residents, are of no greater constitutional concern than those of a private business."[37]

The Department's market participant argument is unavailing, however. No one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds. But Kentucky's issuance of bonds is not the issue. Rather, the sole issue is Kentucky's decision to tax only extraterritorial bonds. Thus, the market participant theory is inapplicable as a State's "assessment and computation of taxes" is, clearly, "a primeval governmental activity."[38] Accordingly, "when a state chooses to tax its citizens, it is acting as a market regulator[,]" not as a market participant.[39] Therefore, the Department's market participant argument is without merit.

Having found that the Department's arguments are unavailing, we are left with a situation in which Kentucky's bond taxation scheme is facially unconstitutional under the Commerce Clause; and none of the arguments in favor of its constitutionality offered by the Department or relied upon by the trial court are sufficient to save it. But under the facts presented in this case, we have no choice but to find that Kentudky's system of taxing only extraterritorial bonds runs afoul of the Commerce Clause.[40] Thus, the trial

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[37] Limbach, 486 U.S. at 277 (internal citations omitted).

[38] *Id.*

[39] Shaper, 647 N.E.2d at 764.

[40] As noted previously, although the cases are distinguishable, Kentucky Courts have previously struck down legislation for violating the Commerce Clause, such as when the Kentucky Supreme Court struck down statutes providing for different levels of *ad valorem* taxation on in-state and out-of-state bank deposits. *See* St. Ledger, 912 S.W.2d 34, and St. Ledger v. Commonwealth, 942 S.W.2d 893 (Ky. 1997).

court's decision to grant summary judgment to the Department was erroneous.[41]

B. Standing.

The trial court found that the Davises lacked standing to assert claims on behalf of all non-individual claimants (i.e., corporations, trusts, estates, etc.) because they had not shown that they had been forced to pay any taxes on extra-territorial bonds on behalf of those types of entities. On appeal, the Davises contend that the trial court confused the concept of standing with the somewhat related issues involved in class certification. We agree.

Class actions in Kentucky are governed by Rules of Civil procedure (CR) 23.01-23.04. The Davises' complaint sets forth their intention to prosecute their claims as a class action on behalf of all individuals, corporations, trusts, estates, etc. CR 23.03(1) provides that "[a]s soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained." Thus, "[i]n a class action a plaintiff generally files a motion seeking certification of the class even though this is not expressly required by statute or rule."[42] In the case at hand, the Davises had not filed a motion for class certification before the Department filed its motion for summary judgment. So any issues regarding the propriety of class certification were not before the trial court. Rather, the only issues before the trial court were whether the bond taxation system in question was constitutional and whether the Davises had basic standing to file the action.

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[41] The trial court made no explicit findings regarding the Davises' Equal Protection arguments. Given our Commerce Clause analysis, we also find it unnecessary to engage in an Equal Protection analysis.

[42] 59 Am.Jur.2d *Parties* § 98 (2002).

The question of standing only goes to whether an individual is entitled to have his or her claims resolved by a court.[43] Thus, although standing is a threshold issue and a prerequisite for all actions, in order to demonstrate standing, a party need only show that a case or controversy exists between that party and the defendant.[44] Only after a plaintiff has established personal standing in a putative class action may a court consider the separate issue of whether the plaintiff will be able to represent the proposed class adequately under the guidelines of CR 23.01-23.04.[45]

In the case at hand, the trial court found that the Davises had personal standing to assert claims regarding the bond taxation issue.[46] Thus, the Davises have standing. The question of whether the Davises may properly represent corporations, trusts, and estates comes into play only when the issue of class action certification is presented. Thus, the portion of the trial court's opinion finding that the Davises lack standing is vacated. Upon remand, the Davises will, presumably, quickly move for class certification, at which time, the trial court may determine all of the issues involved in resolving such a matter, including whether the Davises can properly represent any corporations, trusts or estates.[47]

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[43] *See*, e.g., Fallick v. Nationwide Mutual Ins. Co., 162 F.3d 410, 422 (6th Cir. 1998).

[44] *Id.* at 422-423.

[45] *Id.* at 423.

[46] The trial court's summary judgment order states that "[t]he plaintiffs do maintain standing in regard to KRS 141.020, which relates to an individual income tax paid by them." Appellants' Brief, Appendix 3, p. 4.

[47] The Davises ask us to order the trial court to certify this as a class action. We decline that invitation, however, as such an issue is one which must be initially determined by the trial court.

IV. CONCLUSION.

For the foregoing reasons, the Jefferson Circuit Court's order granting summary judgment to the Department of Revenue is vacated; and this case is remanded for further proceedings consistent with this opinion.

ALL CONCUR.

BRIEFS AND ORAL ARGUMENT FOR APPELLANTS:
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David W. Gray
Anthony Raluy
Louisville, Kentucky

John R. Wylie
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BRIEF AND ORAL ARGUMENT FOR APPELLEES:
Douglas M. Dowell
Frankfort, Kentucky

SUPREME COURT OF KENTUCKY

2006-SC-105-D
(2004-CA-1940-MR)

DEPARTMENT OF REVENUE, ETC.,
ET AL. - - - - - - - - - - *Movants*

v.

GEORGE W. DAVIS and
CATHERINE DAVIS - - - - - *Respondents*

Jefferson Circuit Court
2003-CI-3282

ORDER DENYING DISCRETIONARY REVIEW

The motion for discretionary review of the decision of the Court of Appeals is denied.

Minton, J., not sitting.

ENTERED August 17, 2006.

/s/ Joseph E. Lambert
Chief Justice

NO. 03CI03282

JEFFERSON CIRCUIT COURT

DIVISION ONE

GEORGE W. DAVIS and
CATHERINE DAVIS - - - - - - - *Plaintiffs*

v.

REVENUE CABINET, COMMONWEALTH
OF KENTUCKY, et al. - - - - - - *Defendants*

ORDER GRANTING DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

This matter came before the Court on the motion of defendants Commonwealth of Kentucky Revenue Cabinet and Commonwealth of Kentucky Finance and Administration Cabinet ("defendants") for summary judgment. Plaintiffs George W. Davis and Catherine V. Davis ("plaintiffs") filed a response on August 22, 2003. The defendants filed a reply on September 12, 2003. Oral arguments were held on September 29, 2003. The plaintiffs were represented by attorneys Irvin D. Foley, M. Stephen Dampier, Tammy McClendon Stokes, Scott Barrett and Donn H. Wray. The defendants were represented by attorneys Debra H. Eucker and Douglas M. Dowell. The official proceedings were recorded on videotape no. 30-01-03-079-A-1.

FACTUAL BACKGROUND

On April 11, 2003, the plaintiffs filed a class action complaint for a declaratory judgment, injunction and tax refunds. The plaintiffs brought this action on their behalf and as representatives of a class composed of all person who have paid Kentucky Income Tax ("KIT") on interest income derived from out-of-state municipal bonds and/or their political subdivisions during the class period.

LEGAL ANALYSIS

In Steelvest, Inc. v. Scansteel Service Center, Ky., 807 S.W.2d 476 (1991), the Court looked to the holding in Paintsville Hospital Co. v. Rose, Ky., 683 S.W.2d 255 (1985) for the standard for summary judgment in Kentucky. In Paintsville Hospital, the Court found that summary judgment is proper only when the movant shows that the adverse party cannot prevail under any circumstances. There must be no genuine issues of material fact, and the moving party must be entitled to judgment as a matter of law. Scifres v. Kraft, Ky. App., 916 S.W.2d 779, 780 (1996). The record must be viewed in the light most favorable to the party opposing the motion for summary judgment, and all doubts are to be resolved in his favor. Dossett v. New York Mining and Manufacturing Co., Ky., 451 S.W.2d 843 (1970).

The defendants assert that the plaintiffs lack standing to challenge the constitutionality of the provisions of Kentucky income tax law relating to corporations, estates, trusts and fiduciaries. It is averred that the plaintiffs have standing only to challenge the individual income tax imposed by KRS 141.020. The defendants also argue that KRS 141.020 is entitled to a strong presumption of constitutionality and does not violate the Commerce Clause or Equal Protection Clause of the United States Constitution. The defendants contend that if, in fact, KRS 141.010(10)(c) is unconstitutional, the remainder of the income tax law would still be valid and operational.

In their response, plaintiffs argue that they have standing to assert their claims. They also contend that Kentucky's taxation of interest on bonds issued by other states and their political subdivisions unconstitutionally discriminates against interstate commerce and violates the Equal Protection Clause of the United States Constitution. The plaintiffs concur with the defendants' position that the Court need not invalidate the entire Kentucky Income Tax statute in order to find a part of it unconstitutional.

Intheir reply, the defendants assert that Bonaparte v. Tax Court, 104 U.S. 592 (1881) is controlling and disposi-

tive of the plaintiffs claims. Additionally, the defendants argue that the plaintiffs cannot seek tax refunds by a direct original action such as the one before this Court.

Before the Court can reach the merits of this case, the issue of standing must be resolved. The United States Supreme Court has provided three requirements for standing:

> (1) The plaintiff must have suffered an "injury in fact" — an invasion of a legally protected interest which is (a) concrete and particularized, and (b) actual or imminent, and
>
> (2) There must be a causal connection between the injury and the conduct complained of, and
>
> (3) It must be likely, as opposed to merely speculative, that the injury will be redressed by a favorable decision

Lujan v. Defenders of Wildlife, 504 U.S. 555, 560-61 (1992); Rosen v. Tennessee Commissioner of Finance and Administration, 288 F.3d 918 (6th Cir. 2002). The burden of establishing standing is on the party seeking federal court action. Lujan at 561-62. It is well settled that, at the commencement of litigation, class representatives without personal standing cannot base standing on injuries suffered by members of the class but which they themselves have not or will not suffer. Warth v. Seldin, 422 U.S. 490, 501 (1975). If the plaintiffs apply for and receive certification, they would have standing in respect to the claims included in their original complaint. The certification of a class requires a finding that the named plaintiffs had a stake. Since the plaintiffs in the case-at-bar have acknowledged that they have not applied for certification at this time, the Court must decide the issue of standing by considering the current status of the parties.

The Court finds that the plaintiffs lack standing in regard to KRS 141.030 and KRS 141.040. As stated by the defendants, these two statutes pertain to the income taxes paid by corporations, estates, trusts and fiduciaries. The plaintiffs cannot establish that they have suffered any in-

jury, in fact, as required by the three prong test in Lujan, supra. The plaintiffs do maintain standing in regard to KRS 141.020, which relates to an individual income tax paid by them.

There is a clear presumption in favor of the constitutionality of a statute. Dawson v. Birenbaum, Ky., 968 S.W.2d 663 (1998). The test of the constitutionality of a statute is whether it is "unreasonable or arbitrary." Buford v. Commonwealth, Ky. App., 942 S.W.2d 909, 911 (1997); Moore v. Ward, Ky., 377 S.W.2d 881 (1964). The statute will be determined to be constitutionally valid if a reasonable, legitimate public purpose for it exists, whether or not we agree with its wisdom or expediency. Walters v. Bindner, Ky., 435 S.W.2d 464, 467 (1968).

When a state issues municipal bonds, it participates in the bond market by supplying bonds to the market and paying interest on those bonds. Whether the state is viewed as a market-participant or as using its proprietary powers, or both, it clearly may pay a higher rate of interest to resident purchasers based upon the theories of distributing state created benefits and market participation. This practice can be analogized to granting property tax breaks to various businesses, but not to others, in order to encourage businesses to remain in the state. Reeves v. Stake, 447 U.S. 429 (1980); see also Scott K. Attaway, Note, The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds, 76 B.U. L. Rev. 737 (1990). Considering the entire transaction, the tax exemption granted to resident purchasers of municipal bonds qualifies under those doctrines which permit burdens on interstate commerce in certain limited contexts and is, therefore, not the type of burden with which the Commerce Clause is concerned. Hughes v. Alexandria Scrap Corp. 426 U.S. 794, 805 (1976); Attaway at 760-761.

States have a legitimate interest in attracting local funds for local public works projects. Constitutionally permissible resident preferences encourage states and cities to improve the lives of their citizens by keeping the ben-

efits they generate within their borders. Each state has a legitimate interest in drawing upon a major source of tax revenue while creating an incentive for investors to purchase state bonds. The purchasers ultimately become the major beneficiaries of the issuance of the bonds for state issues such as capital improvements as quality schools, hospitals and roads. Shaper v. Tracy, 647 N.E.2d 550 (Ohio Ct. App. 1994); Attaway at 768.

The Court finds that KRS 141.020 has a reasonable, legitimate public purpose. Therefore, the statute is constitutional, while the plaintiff may not agree with the statute's purpose, that fact alone does not require the Court to make a finding of unconstitutionality.

IT IS HEREBY ORDERED that the motion of defendants Commonwealth of Kentucky Revenue Cabinet and Commonwealth of Kentucky Finance and Administration Cabinet for summary judgment is **GRANTED.**

Ths is a final and appealable order, and there is no just cause for delay.

/s/ BW
JUDGE BARRY WILLETT
JEFFERSON CIRCUIT COURT

cc: Irvin D. Foley, Esq./David W. Gray, Esq./Anthony G. Raluy, Esq./Charles R. Watkins, Esq./John R. Wylie, Esq./M. Scott Barrett, Esq./Dennis T. Trainor, Esq./ David J. Guin, Esq./Tammy M. Stokes, Esq./M. Stephen Dampier, Esq./Hart L. Robinovitch, Esq./Donn H. Wray, Esq.

Douglas M. Dowell, Esq./ Debra H. Eucker, Esq.

KY. REV. STAT. ANN. § 141.010

As used in this chapter, unless the context requires otherwise:

* * * * *

(7) "Individual" means a natural person;

* * * * *

(9) "Gross income" in the case of taxpayers other than corporations means "gross income" as defined in Section 61 of the Internal Revenue Code;

(10) "Adjusted gross income" in the case of taxpayers other than corporations means gross income as defined in subsection (9) of this section minus the deductions allowed individuals by Section 62 of the Internal Revenue Code and as modified by KRS 141.0101 and adjusted as follows, except that deductions shall be limited to amounts allocable to income subject to taxation under the provisions of this chapter, and except that nothing in this chapter shall be construed to permit the same item to be deducted more than once:

* * * * *

(c) Include interest income derived from obligations of sister states and political subdivisions thereof;

* * * * *

(11) "Net income" in the case of taxpayers other than corporations means adjusted gross income as defined in subsection (10) of this section, minus the standard deduction allowed by KRS 141.081, or, at the option of the taxpayer, minus the deduction allowed by KRS 141.0202, minus any amount paid for vouchers or similar instruments that provide health insurance coverage to employees or their families, and minus all the deductions allowed individuals by Chapter 1 of the Internal Revenue Code as modified by KRS 141.0101 except those listed below, except that deductions shall be limited to amounts allocable to income subject to taxation under the provisions of this chapter and that nothing in this chapter shall be

construed to permit the same item to be deducted more than once:

* * * * *

(16) "Taxable year" means the calendar year or fiscal year ending during such calendar year, upon the basis of which net income is computed, and in the case of a return made for a fractional part of a year under the provisions of this chapter or under regulations prescribed by the commissioner, "taxable year" means the period for which the return is made;

(17) "Resident" means an individual domiciled within this state or an individual who is not domiciled in this state, but maintains a place of abode in this state and spends in the aggregate more than one hundred eighty-three (183) days of the taxable year in this state;

(18) "Nonresident" means any individual not a resident of this state;

* * * * *

KY. REV. STAT. ANN. § 141.020

(1) An annual tax shall be paid for each taxable year by every resident individual of this state upon his entire net income as defined in this chapter. The tax shall be determined by applying the rates in subsection (2) of this section to net income and subtracting allowable tax credits provided in subsection (3) of this section.

* * * * *

(4) An annual tax shall be paid for each taxable year as specified in this section upon the entire net income except as herein provided, from all tangible property located in this state, from all intangible property that has acquired a business situs in this state, and from business, trade, profession, occupation, or other activities carried on in this state, by natural persons not residents of this state. A nonresident individual shall be taxable only upon the amount of income received by the individual from labor performed, business done, or from other activities in this

state, from tangible property located in this state, and from intangible property which has acquired a business situs in this state; provided, however, that the situs of intangible personal property shall be at the residence of the real or beneficial owner and not at the residence of a trustee having custody or possession thereof. The remainder of the income received by such nonresident shall be deemed nontaxable by this state.

* * * * *

(6) An individual who becomes a resident of Kentucky during the taxable year is subject to taxation as prescribed in subsection (4) of this section prior to establishing such residence and as prescribed in subsection (1) of this section following the establishment of such residence.

(7) An individual who becomes a nonresident of Kentucky during the taxable year is subject to taxation, as prescribed in subsection (1) of this section, during that portion of the taxable year that the individual is a resident and, as prescribed in subsection (4) of this section, during that portion of the taxable year when the individual is a nonresident.

* * * * *

103 KY. ADMIN. REGS. 17:060

* * * * *

Section 1. Residents. The entire net income of a full-year resident individual shall be subject to Kentucky income tax regardless of its source. Income from out-of-state sources shall not be exempt. The adjustments to gross income and itemized deductions allowed under KRS 141.010(10) and (11) of a full-year resident shall not be limited to those paid in Kentucky.

Section 2. Persons Becoming Residents During the Year. (1) Persons who become Kentucky residents during the year shall be subject to Kentucky individual income tax upon their entire net incomes from any source after

becoming Kentucky residents and upon their incomes from Kentucky sources prior to becoming Kentucky residents.

* * * * *

Section 3. Persons Becoming Nonresidents During the Year. (1) Persons who are Kentucky residents, but become nonresidents during the year, shall be subject to Kentucky individual income tax upon their entire net incomes from all sources while they are Kentucky residents, and upon their incomes from Kentucky sources after becoming nonresidents.

* * * * *

Section 4. Nonresidents. (1) Any net income of a nonresident shall be subject to Kentucky income tax if it is derived from services performed in Kentucky or from property located in Kentucky. Income from sources outside Kentucky shall not be subject to Kentucky income tax.

* * * * *

No. 06-666

In The Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY and FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,

Petitioners,

versus

GEORGE W. DAVIS and CATHERINE V. DAVIS,

Respondents.

On Petition For A Writ Of Certiorari To The Kentucky Court Of Appeals

BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION

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Jerome R. Hellerstein and Walter Hellerstein, STATE TAXATION (3d ed. 2001) 7

COUNTERSTATEMENT OF THE CASE

The Commonwealth of Kentucky's revenue code taxes "interest income derived from obligations of sister states and political subdivisions thereof," KRS 141.010(10)(c) and 12(c), but expressly exempts from taxation the interest income from its own state and municipal bonds, Ky. Const. § 171. Respondents George W. Davis and Catherine V. Davis, on behalf of themselves and others (collectively herein the "Respondents" or "Davises"), brought this suit against the Petitioners, the Commonwealth of Kentucky Revenue Cabinet and Commonwealth of Kentucky Finance and Administration Cabinet (collectively herein the "Petitioners"), alleging that Kentucky's tax scheme violates the Commerce Clause. The Davises seek, on their own behalf and on behalf of all others who were also required to include as part of their state taxable income the earnings they received from bonds issued by states other than Kentucky, a declaration that the tax is unconstitutional, an injunction to prevent further enforcement of the tax, and a refund of the unconstitutional taxes paid.

The trial court entered summary judgment in favor of the Petitioners. The Kentucky Court of Appeals reversed the trial court's decision, finding that Kentucky's tax scheme facially discriminates against interstate commerce and thereby violates the Commerce Clause. *Davis v. Department of Revenue of the Finance and Administration Cabinet, et al.*, 197 S.W. 3d 557, 564 (Ky. Ct. App. 2006).[1]

---

[1] Having held the tax scheme unconstitutional as a violation of the Commerce Clause, the Kentucky Court of Appeals did not address the Davises' federal Equal Protection and state Uniformity Clause claims.

The Petitioners moved the Kentucky Supreme Court for discretionary review, which the court denied on August 17, 2006. Pet. App. at p. 14. The Petitioners then sought further review from this Court on November 9, 2006.

REASONS FOR DENYING THE WRIT

The Petitioners have presented no compelling reason for this Court to review the Kentucky Court of Appeals' finding that Kentucky's bond tax scheme violates the dormant Commerce Clause. The decision is wholly consistent with this Court's dormant Commerce Clause precedent, and the Petitioners have not presented any issue that needs further review or clarification by this Court. Instead, the Petitioners disregard this Court's long line of dormant Commerce Clause precedent and urge this Court to grant certiorari because other states have discriminatory tax schemes, and because Petitioners claim a need to discriminate to protect their illegally-secured market position.

Even if there is an issue of interest to this Court in this case, other state tax and appellate courts are currently considering the same issues presented by the Petition. The Court should deny the petition and allow these issues to percolate further in the state courts. Moreover, the only opinion to conflict with that of the Kentucky Court of Appeals – *Shaper v. Tracy*, 647 N.E.2d 550 (Ohio Ct. App. 1994) – was decided prior to this Court's further development of the dormant Commerce Clause law in *Camps Newfound/Owatonna v. Town of Harrison, Maine*, 520 U.S. 564 (1997), *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) and *Granholm v. Heald*, 544 U.S. 460 (2005), for example. Even *Shaper* is consistent with the

Kentucky Court of Appeals with respect to Petitioners' primary issue presented here, that is whether Kentucky acts as a "market participant" in its taxation of extraterritorial bond interest. Thus, it remains to be determined whether any conflict among the states currently exists.

I. THE KENTUCKY COURT OF APPEALS' DECISION IS WHOLLY CONSISTENT WITH THIS COURT'S EXTENSIVE COMMERCE CLAUSE PRECEDENT.

A. The Kentucky Court of Appeals' Decision Is Consistent with the Commerce Clause's Prohibition Against Discriminatory Taxes.

Kentucky's tax scheme at issue here taxes income coming into Kentucky from the bonds of sister states and their political subdivisions, but exempts from taxation income derived from in-state bonds, thus providing either beneficial or burdensome tax treatment based solely on the income's state of origin.

It is a well-settled principle of law that "'[a] State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State.'" *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334, 342 (1992) (quoting *Armco v. Hardesty*, 467 U.S. 638, 642 (1984)); *see also Fulton Corp. v. Faulkner*, 516 U.S. 325, 339 (1996) ("a state tax impermissibly discriminates against interstate commerce when the state's taxing power effectively increases the tax burden for out-of-state transactions, thereby coercing taxpayers to conduct intrastate rather than interstate business."). Indeed, "[t]ime and again this Court has held that, in all but the narrowest

circumstances, state laws violate the Commerce Clause if they mandate 'differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.'" *Granholm v. Heald*, 544 U.S. 460, 472 (2005) (quoting *Oregon Waste Sys. v. Department of Environmental Quality of Oregon*, 511 U.S. 93, 99 (1994)).

Without question, Kentucky's bond tax scheme "effectively increases the tax burden for out-of-state transactions, thereby coercing taxpayers to conduct intrastate rather than interstate business." *Fulton Corp.*, 516 U.S. at 339. In fact, virtually admitting that it violates the Commerce Clause, the Petitioners argue that the *very purpose* of the tax scheme is to discriminate so as to give an advantage in the financial markets to the state's bonds over those of sister states (or of other competing non-governmental debt instruments), in order to induce its residents to purchase the former instead of the latter. *See* Pet. at p. 12, 16. The Kentucky Court of Appeals concluded that "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." Pet. App. at p. A6. As a result, the court properly held that "under the facts presented in this case, we have no choice but to find that Kentucky's system of taxing only extra-territorial bonds runs afoul of the Commerce Clause." Pet. App. at p. A10.

The Kentucky court's decision was based upon, and is fully consistent with, this Court's repeated interpretation of Commerce Clause restrictions on state regulatory measures that affect interstate commerce. Most recently, in *Granholm v. Heald*, in which this Court struck down restrictive wine importation laws in Michigan and New York that favored in-state producers over their out-of-state

rivals. The Court reminded that "[w]hen a state statute directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry." *Granholm*, 544 U.S. at 487 (internal citations omitted); *see also New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273-74 (1988); *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334, 342 (1992).

The Court's condemnation of discriminatory statutes has been particularly strong in the context of taxation. *See Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 331 (1977) (Court invalidating New York statute that reduced the transfer tax on securities sales if the sale of securities took place on an exchange within the state because the tax scheme "foreclos[ed] tax neutral decisions" and "creat[ed] both an advantage for the exchanges in New York and a discriminatory burden on commerce to its sister States."); *Fulton Corp. v. Faulkner*, 516 U.S. 325, 328 (1998) (Court invalidating as violative of the Commerce Clause North Carolina's "intangibles tax" under which the state allowed residents a tax deduction in an amount "equal to the fraction of the issuing corporation's income subject to tax in North Carolina").[2]

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[2] The Court reasoned:

> There is no doubt that the intangibles tax facially discriminates against interstate commerce. A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Id. at 333.

The Kentucky courts have consistently adhered to and enforced this Court's Commerce Clause jurisprudence, striking down another of Kentucky's discriminatory state taxes, an *ad valorem* bank deposit tax, because it taxed out-of-state bank deposits at a higher rate than in-state deposits. *See St. Ledger v. Commonwealth of Kentucky, Revenue Cabinet*, 912 S.W. 2d 34, 39 (Ky. 1995), *vacated on other grds.*, 517 U.S. 1206 (1996). The Kentucky Supreme Court reasoned:

> Residents making a choice of where to deposit funds will be influenced by the higher tax rate on out-of-state deposits. As a result, the statute "forecloses tax-neutral decisions and creates both an advantage for the [Kentucky banks] and a discriminatory burden on commerce to its sister states."

St. Ledger, 912 S.W. 2d at 39 (quoting *Boston Stock Exchange*, 429 U.S. at 331). Describing itself as "bound by constitutional proscriptions," the Kentucky high court found the discriminatory tax "clearly violative of the commerce clause." *Id.*

The tax schemes found infirm in all of these cases ensured that a taxpayer would consider the state tax implications of his transactions in deciding where to conduct business. The same is true here; in fact, according to the Petitioners, that is its very purpose. Pet. at p. 12, 16. Thus, the Kentucky court's decision invalidating the challenged tax scheme as facially unconstitutional under the Commerce Clause rests on solid precedent. Nothing provided by the Petitioners here suggests otherwise.

The fact that other states have similar protectionist tax measures does not bolster the Petitioners' argument

against this Court's Commerce Clause precedent. Rather, as this Court found in *Granholm*, it is simply evidence of the balkanizing effect of discriminatory tax provisions:

> The current patchwork of laws – with some States banning direct shipments altogether, others doing so only for out-of-state wines, and still others requiring reciprocity – is essentially the product of an ongoing low-level trade war. Allowing States to discriminate against out-of-state wine "invite[s] a multiplication of preferential trade areas destructive of the very purpose of the Commerce Clause."

Granholm, 544 U.S. at 473; *see also* Jerome R. Hellerstein and Walter Hellerstein, STATE TAXATION at ¶ 4.13[2][e] (3d ed. 2001) (referring specifically to discriminatory state and municipal bond taxes at issue here and concluding "if ever one needed proof that such discriminatory state taxes [on extra-territorial state and municipal bond interest] Balkanize our national capital markets, one need look no further than the state-specific municipal bond funds that have arisen directly as a result of these discriminatory state taxes.").

B. The Kentucky Court of Appeals' Decision, Consistent with this Court's Precedent, Found No Valid Justification for Kentucky's Discriminatory Tax.

Facially discriminatory taxes, like Kentucky's bond tax scheme, "[are] virtually *per se* invalid," *Oregon Waste*, 511 U.S. at 99; *see also Granholm*, 544 U.S. at 476. Such "state statutes that clearly discriminate against interstate commerce are routinely struck down, unless the discrimination is demonstrably justified by a valid factor *unrelated to economic protectionism*." *New Energy Co. of Indiana*, 486

U.S. at 273-74 (emphasis added); *see also Granholm*, 544 U.S. at 487 ("When a state statute directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry.") (internal quotations omitted); *Chemical Waste Management*, 504 U.S. at 342 (same).

When faced with a Commerce Clause challenge to a facially discriminatory statute, the state must provide "more than mere speculation to support discrimination against out-of-state goods. The burden is on the State to show that the *discrimination* is demonstrably justified." *Granholm*, 544 U.S. at 492 (internal quotations omitted) (emphasis in original). The Petitioners offered ***no*** valid justification to the Kentucky courts (or this Court), much less a compelling one, for their discriminatory tax scheme.

1. Economic Protectionism Is Not a Valid Justification for Discrimination.

Despite this Court's repeated admonition that a legitimate justification must be "unrelated to economic protectionism," the Petitioners boldly admit that the only purpose for their discriminatory bond tax scheme *is* economic protectionism:

- "The tax exemption influences a Kentucky resident to choose to acquire a bond issued by Kentucky or a Kentucky municipality over a bond issued by another state or other state's municipality that pays a higher rate of interest or has a stronger credit rating. If the Kentucky court's decision stands, state and local governments will lose this important edge. . . ." Pet. at p. 12.

- "It [the tax scheme] makes bonds of Kentucky and its political subdivisions competitive in this limited market with corporate bonds and bonds of other states. . . ." Pet. at p. 16.[3]

The Kentucky court recognized that fact, and for that reason, correctly held Kentucky's tax scheme unconstitutional.[4]

2. The Petitioners' Proffered Financial Implications of the Kentucky Court of Appeals' Decision Are Both Unsupported and Incorrect, Providing No Valid Justification for the State's Discriminatory Tax Scheme.

In the absence of any legal error in the Kentucky Court of Appeals' decision, the Petitioners have resorted to factually unsupported policy arguments, claiming that the court's decision will wreak financial havoc on the state. At least one economic study, however, refutes the Petitioners' arguments, concluding that states would actually *benefit* by ceasing their practice of exempting taxes on income derived from in-state bonds. *See* Cole, C. Steven, *et al.*, "The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields," 7 J. Fin. and Strategic Decisions 67 (Summer 1994) (available at http://www.studyfinance.com/

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[3] These admissions also refute the Petitioners' claims that Kentucky is "not similarly situated with" other states. Indeed, if they were not similarly situated, then Kentucky would have no need to discriminate in order to compete with the other states.

[4] As Petitioners admit, Pet. at p. 16, Kentucky's use of its taxation power to gain market share from competing states also puts non-governmental issuers of debt securities at a disadvantage and deprives investors of a free and open market.

jfsd/pdffiles/v7n2/cole.pdf#search+'journal%20decisions%20capitalization%20of%20the%20state%20tax%20exemption'). The authors of that study reported that:

> [T]he costs to the state in the form of the lost tax revenues due to tax exemptions is significantly greater than the benefit in the form of reduced yields for in-state bond issues. In other words, the tax exemption is not a beneficial way to stimulate demand for in-state bond issues.

Id. at 68. Thus, whereas the Petitioners may speculate that they can reduce their borrowing costs by exempting taxes of in-state buyers, this study concluded otherwise, finding "that the cost to the states in the form of lost tax revenues is significantly greater than the estimated benefit of reduced interest costs to in-state issuers." *Id.* at p. 73. This conclusion is further supported by the fact that other states, such as Illinois, do not discriminate and yet have not experienced the grave financial impacts about which the Petitioners speculate. Instead, if the states would simply comply with the Commerce Clause and either tax all state and municipal bond interest or exempt all such bond interest, the states, taxpayers and investors would all benefit.

Discrimination arbitrarily limits the market for a state's bonds. By exempting interest earned on its own financial instruments from state income tax, while taxing the interest earned on the other states' financial instruments, Kentucky has limited the market for its own investment offerings by offering an uncompetitive after-tax interest rate to non-residents. By complying with the Constitution, states will open their investment sales to the

entire national market for debt instruments.[5] Thus, the Petitioners' desire to protect an unconstitutional tax scheme may actually be to the state's financial detriment and again refutes any need for review by this Court.

C. Actions of Market Regulators Are *Not* Exempt from the Commerce Clause.

The Petitioners argue that this Court should grant review because their discriminatory tax scheme is nothing more than the act of a "market participant" and so not subject to Commerce Clause restrictions. This Court has regularly rejected arguments, such as the Petitioners make here, that attempt to equate taxation with market participation. In *New Energy Co. of Indiana*, for example, the Court held that the market participant doctrine did not shelter an Ohio sales tax credit given for the sale of ethanol produced in Ohio or in a sister state that gave a similar tax credit for ethanol produced in Ohio, but not for ethanol produced in other states. The Court explained:

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[5] Once states compete in the financial markets without the protective benefit of coercive tax schemes, they will have to be more selective in what projects they choose to fund. They will compete for investors' dollars not just with respect to the interest rate offered, but on the merits of the projects funded by the investment sales. Indeed, Petitioners admit that a purpose of Kentucky's discriminatory tax scheme is to attract investors away from competitors' more creditworthy investments. Pet. at p. 12. As a result, the market will provide incentives for governments to be more careful in selecting and funding projects through bond sales. Likewise, investors will benefit from greater investment choices. Rather than being coerced by competing state tax codes to invest in their home states' projects – even if those bonds are less secure or fund less beneficial projects than those sold by competing states – they can choose their debt investments from a wider menu.

> The market-participant doctrine has no application here. The Ohio action ultimately at issue is neither its purchase nor its sale of ethanol, but its assessment and computation of taxes – a primeval governmental activity. To be sure, the tax credit scheme has the purpose and effect of subsidizing a particular industry, as do many dispositions of the tax laws. That does not transform it into a form of state participation in the free market.

New Energy Co. of Indiana, 486 U.S. at 277.

The Court similarly held in *Camps Newfound/Owatonna, Inc.* that "a tax exemption statute cannot be characterized as a proprietary activity falling within the market-participation exception. . . . A tax exemption, even one that has the effect of a subsidy, is not the sort of direct state involvement in the market that falls within the market-participant doctrine." *Camps Newfound/Owatonna, Inc.*, 520 U.S. at 593; *see also Walling v. People*, 116 U.S. 446, 455 (1886) ("a discriminatory tax . . . is, in effect, a regulation in restraint of commerce among the States. . . .").

Thus, while a state may lawfully enter the market and engage in trade as a market participant the same as a private citizen, this Court has resolutely held that the basis for the market participant doctrine lies in the state's proprietary use of its own resources, *not* in the exercise of its regulatory taxing authority. Indeed, "[t]he grant of a tax exemption is not sponsorship since the government does not transfer part of its revenues," *Walz v. Tax Comm'n of City of New York*, 397 U.S. 664, 675 (1970), such as a market participant would. *See, e.g., Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 806-10 (1976) (state held to be market participant due to the fact that it bought

scrap metal). The fact that Kentucky's tax scheme may benefit its actions as a market participant does not render its act of taxation one and the same as a market participant. A state's exercise of its taxing power is a separate and distinct action; and as this Court repeatedly has noted, taxation is the quintessential action of a market regulator, not a market participant. Such regulatory actions are always subject to the Commerce Clause restrictions of the state's power.[6]

Thus, as the Kentucky Court of Appeals correctly found, while it may be true that Kentucky acts as a market participant in the *sale* of its bonds, it clearly does not do so in *taxing* the income from the bonds of other states while exempting the income its residents derive from intrastate bonds. *See Shaper v. Tracy*, 647 N.E. 2d 550, 552 (Ohio Ct. App. 1994) ("[W]hen a state chooses to sell bonds and enter into the securities market, it is acting as a market participant. However, when a state chooses to tax its citizens, it is acting as a market regulator."). Although the Petitioners attempt to blur that distinction, their arguments are contrary to this Court's precedent and provide no reason for this Court to grant review in this case.

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[6] Moreover, it is well-established that a state may be a market participant in one aspect of a program while operating as a market regulator in implementing another. Therefore, courts must carefully review every aspect of a state's activity to determine whether it is one of a market participant or market regulator, *see, e.g., South-Central Timber Development v. Wunnicke*, 467 U.S. 82, 97-99 (1984) (Court distinguishing between state's action as market participant and market regulator), contrary to the Petitioners' attempt to blend the two separate actions into one.

D. The Kentucky Court of Appeals, Consistent with this Court's Precedent, Properly Held the State's Powers of Taxation Subject to the Commerce Clause.

To suggest that the Commerce Clause was not intended to apply where a state "is acting on its own behalf," Pet. at p. 14, is completely lacking in merit. This Court refuted this argument in *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82 (1984), wherein the State of Alaska attempted to restrict its sale of timber from state lands through the use of its state regulatory authority.[7] Furthermore, the argument is consistent with "[t]he very purpose of the Commerce Clause [which] was to create an area of free trade among the several states." *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330 (1944); *see also Boston Stock Exchange*, 429 U.S. at 329 (Recognizing that the inherent limitation of a state's power to discriminate against interstate commerce "follows inexorably from the basic purpose of the Clause.").

The Petitioners' cited authority for this argument, the Ohio Court of Appeals' decision in *Shaper*, provides no support for their conclusion that the Commerce Clause does not apply to a state's tax designed to favor itself in its market activities. Indeed, unlike the Kentucky Court of Appeals here, the *Shaper* court failed to consider this Court's prior holdings that support the opposite conclusion.

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[7] The Court reasoned that "although the State may be a participant in the timber market, it is using its leverage in that market to exert a regulatory effect in the processing market ... " and thus violating the Commerce Clause. *Id.* at 98.

The Petitioners' reliance on *Reeves, Inc. v. Stake*, 447 U.S. 429 (1980), is similarly misplaced. Although the Petitioners cite *Reeves* as providing that under the Commerce Clause, there is "no indication of a . . . plan to limit the ability of the States themselves to operate freely in the free market," Pet. at 15 (quoting *Reeves*, 447 U.S. at 437), this quote is taken out of context. The Petitioners fail to include this Court's citation to Professor Tribe's discussion of the Commerce Clause which puts the statement in its proper context. *See Reeves*, 447 U.S. at 437 (quoting L. Tribe, American Constitutional Law 336 (1978) ("the commerce clause was directed, as an historical matter, only at regulatory and taxing actions taken by states in their sovereign capacity")). The Petitioners' inaccurate recounting of this decision is even more apparent when viewed in conjunction with the immediately preceding paragraph which insightfully provides, "[t]he basic distinction drawn . . . between States as market participants and States as market regulators makes good sense and sound law. . . . [T]he Commerce Clause responds principally to state taxes and regulatory measures impeding free private trade in the national marketplace. . . ." *Id.* at 437.[8]

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[8] The Petitioners' only other authority cited in support of this argument, *Bonaparte v. Tax Court*, 104 U.S. 592 (1881), is equally unpersuasive. As the Petitioners candidly admit, the tax in *Bonaparte* was not challenged on Commerce Clause grounds, nor was the type of discriminatory tax challenged here at issue in *Bonaparte*. Instead, that case dealt only with the question of whether one state could tax interest earned by its own residents on the debt of another state. As the Court explained:

> The question we are asked to decide in this case is whether the registered public debt of one state, exempt from taxation by the debtor state, or actually taxed there, is taxable by another state when owned by a resident of the latter state.

(Continued on following page)

To adopt the Petitioners' argument that the Commerce Clause does not apply to a state's taxation "on behalf of itself where the end result is to provide the taxing state with a competitive advantage over another sovereign" (Pet. at p. 14) would render the dormant Commerce Clause utterly meaningless and undo over a century of Commerce Clause precedent. Invariably, in any case involving the dormant Commerce Clause, one state discriminates (often by using its sovereign powers of taxation) in order to obtain a competitive advantage; and the argument could always be made that the competitive advantage sought was intended ultimately to benefit the state itself, usually with more income. Such "revenue generation[, however,] is not a local interest that can justify discrimination against interstate commerce." *C&A Carbone v. Town of Clarkstown*, 511 U.S. 383, 393 (1994). Moreover, the Court has clearly instructed that "[t]he paradigmatic . . . law discriminating against interstate commerce is the protective tariff or custom duty . . . ," *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 193 (1994), the income from which will always benefit the state.

Against this backdrop, the Court has long adhered to the principle that while "[a] State's power to lay and collect taxes, comprehensive and necessary as that power is, *cannot* be executed in a way which involves a discrimination against [interstate] commerce." *Camps Newfound/ Owatonna*, 520 U.S. at 576 (quoting *Pennsylvania v. West*

Bonaparte, 104 U.S. at 594. The question here is not whether Kentucky can tax its residents' income from other states' municipal bonds, but rather whether it can do so while at the same time exempting from taxation income derived from its own bonds. The *Bonaparte* court was not faced with the latter issue, and its holding is irrelevant to its resolution.

Virginia, 262 U.S. 553, 596 (1923)); *see also Chemical Waste Management, Inc.*, 504 U.S. at 342 (quoting *Armco*, 476 U.S. at 642) (tax discriminates in violation of the Commerce Clause if it "tax[es] a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State."); *Fulton Corp.*, 516 U.S. at 331 ("a state tax impermissibly discriminates against interstate commerce when the state's taxing power effectively increases the tax burden for out-of-state transactions, thereby coercing taxpayers to conduct intrastate rather than interstate business."); *Oregon Waste*, 511 U.S. at 99 (a tax that discriminates against interstate commerce "is virtually *per se* invalid"). As evident from this long line of precedent, a state's power to tax is subject to, and limited by, the Commerce Clause regardless of the purpose for the tax. The Court has never suggested otherwise.

E. The Kentucky Court of Appeals' Decision Does Not Contravene the Tenth Amendment.

As their last effort, the Petitioners suggest that the Kentucky court's decision may run afoul of the Tenth Amendment because it allegedly would require Kentucky to exempt from taxation income from other states' bonds. The decision below contains no such requirement, but instead requires only that Kentucky tax intrastate income no differently than interstate income.

In any event, where, as here, the plaintiff has challenged the constitutionality of a state's tax scheme, the Tenth Amendment does not apply. The Tenth Amendment is merely a restraint on *Congressional* efforts to "compel the States to enact or enforce a federal regulatory program," *Reno v. Condon*, 528 U.S. 141, 149 (2000), and is concerned

with Congressional actions "seek[ing] to control or influence the manner in which States regulate private parties." *South Carolina v. Baker*, 485 U.S. 505, 514 (1988). In the present case, of course, it is the Constitution, not an act of Congress, that prohibits Kentucky's discriminatory tax scheme. Moreover, "[t]hat a State wishing to engage in certain activity must take administrative and sometimes legislative action to comply with federal standards regulating that activity is commonplace and presents no constitutional defect." *Baker*, 485 U.S. at 514-15.

II. THE PETITION IS PREMATURE.

Even if the Petitioners had presented an issue for potential review by this Court, there is no need for the Court to address it at this time. As demonstrated above, the Kentucky Court of Appeals' decision is wholly consistent with this Court's dormant Commerce Clause precedent. In addition, although the Petitioners correctly state that the Ohio and Kentucky Courts of Appeals reached different outcomes in the *Shaper* case and this case, even the Ohio court rejected the principal argument presented by the Petitioners as the basis of their petition here, that is, Kentucky's taxation of out-of-state bond interest is the action of a market participant. Consistent with the Kentucky court in this case, the Ohio court concluded, "when a state chooses to sell bonds and enter into the securities market, it is acting as a market participant. However, when a state chooses to tax its citizens, it is acting as a market regulator." *Shaper*, 647 N.E.2d at 552. Thus, the Petitioners' claim that their discriminatory actions of taxing bond interest on other states' bonds are those of a market participant finds no support in the law, not even from the

Ohio courts; and there is no meaningful conflict among the states on this issue.

Moreover, perhaps explaining its lack of discussion of other relevant Commerce Clause principles, the Ohio decision was rendered well over a decade ago, preceding some of this Court's key Commerce Clause decisions on discriminatory taxes, such as *Camps Newfound/Owatonna*, 520 U.S. 564 (1997) and *Fulton Corp. v. Faulkner*, 516 U.S. 325, 339 (1996).

Finally, the same issue is currently pending before other state tax and appellate courts, including North Carolina and Arizona, but has not yet fully developed in those states. Thus, even if these issues are of interest to the Court, it should refrain from reviewing them until more courts have had the chance to weigh in. Moreover, the passage of time will reveal if there is truly a "split" among the states or if any question of the Commerce Clause's application to states' regulatory powers exists that would necessitate this Court's review of those issues. Until then, these issues are best addressed by the states in accordance with this Court's extensive Commerce Clause precedent.

CONCLUSION

The Petitioners have presented no compelling reason for this Court to review this case; accordingly, the petition for writ of certiorari should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY and FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

versus

GEORGE W. DAVIS and CATHERINE V. DAVIS,
Respondents.

On Petition for a Writ of Certiorari to the Court of Appeals of Kentucky

REPLY BRIEF FOR THE PETITIONERS

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REPLY BRIEF FOR PETITIONER

The Respondents' Brief in Opposition (Opp. 18-19) argues that the petition is "premature" and that other courts should be allowed to "weigh in" on the issue presented. The petition is certainly not premature for the Commonwealth of Kentucky, where the Constitution will have a meaning different from that in Ohio (and all the other states) if the Kentucky Court of Appeals decision is allowed to stand. If the petition is not granted, the Commonwealth will have to accord its bonds the same tax treatment as bonds issued by its sister states and their political subdivisions. *See, e.g.*, *McKesson* v. *Division of Alcoholic Beverages and Tobacco, Department of Business Regulation of Florida*, 496 U.S. 18 31-36, 51-42 (1990); *Davis* v. *Michigan Dept. of Treasury*, 489 U.S. 803, 817-18 (1989). Meanwhile, its sister states and their political subdivisions will be under no obligation to do the same with respect with to bonds issued by the Commonwealth and its political subdivisions, unless their courts opt for the approach taken by the Kentucky Court of Appeals in this case over that taken by the Ohio courts.

Moreover, the Respondents do not make any showing as to what benefit would be derived from "full develop[ment]" of the issue in the Arizona and North Carolina courts. Opp. 19. They do not articulate what that "full develop[ment]" would consist of, either. The reality is that no benefit would lie in awaiting further state court decisions on the issue presented. This issue is purely one of law that can only be settled by this Court. The area of controversy presented by this case is not one that is evolving in nature or depending upon factual development or exploration of doctrinal ramifications.

Instead, the Respondents' approach only significantly delays the resolution of a question of great national importance. There has been no reported decision in the Arizona case to which the Respondents refer. The North Carolina litigation, which is also being handled by the Respondents' counsel, is focused on the question of class certification and

not the merits, *Dunn* v. *State*, 635 S.E.2d 604 (N.C. App. 2006), and is on review to the North Carolina Supreme Court. *Dunn* v. *State*, Supreme Court of North Carolina Docket No. 605P06 (available at http://www.aoc.state.nc.us/www/public/sc/dsheets/605-06-1.htm).

At the same time, the Respondents have not disputed the widespread and substantial impact of the issue presented upon the great majority of the states. On this point, the National Association of State Treasurers, a nonprofit association whose members "include the Treasurers or similar State financial officers of all 50 states," has sought leave to file a brief as amicus curiae in support of the Petitioners. Amicus Br. 1. That brief explains the "vital importance" of municipal bonds "to State and local government entities that issue [them] and to citizens who benefit from government projects and activities financed by [them]," and "the centrality of [the bonds'] tax exempt status." Amicus Br. 4-13. The National Association of State Treasurers "strongly urges the Court to grant review," as the decision of the Kentucky Court of Appeals "has created legal uncertainty that should be resolved promptly, and can only be resolved by this Court." Amicus Br. 4, 5.

The Respondents assert that the petition should be denied because the Kentucky Court of Appeals' decision is "wholly consistent with this Court's extensive Commerce Clause precedent." Opp. 3. They fail to heed this Court's admonitions that "our opinions are to be read in the light of the facts of the case under discussion," *Armour & Co.* v. *Wantock*, 323 U.S. 126, 132-33 (1944), and especially so in the area of the dormant Commerce Clause. *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318, 329 (1977); *Freeman* v. *Hewitt*, 329 U.S. 249, 252 (1946). The Respondents' whole case is premised upon the approach that principles enunciated by this Court in its dormant Commerce Clause jurisprudence must be inexorably followed as far as logic can

carry them, regardless of the context or the possibility of the application of countervailing principles. None of the cases upon which they rely bear any resemblance to the facts or context presented by this case.

The Respondents' argument extends the application of the dormant Commerce Clause well beyond its purpose as expressed by this Court in cases such as *H.P. Hood & Sons, Inc.* v. *Du Mond*, 336 U.S. 525 (1949):

> Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his export, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.

Id. at 539. This case does not involve a measure aimed at the products of a farmer, craftsman or economic interest of another state, but instead concerns whether the means chosen by a state to raise funds to support general government needs or to fund public works projects or programs is qualified by some obligation to it's sister states imposed by the Commerce Clause. The proper answer is that the Constitution specifically addresses the obligations the states owe one another and the obligation advanced by the Respondents is not among them. *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881); U.S. Const. Art. IV, §§ 1-3.

To be sure, the states may not discriminate against interstate commerce and Kentucky has not done so here. Kentucky taxes interest derived from bonds issued by its sister states and their political subdivisions in the same manner as interest from bonds issued by Kentucky's intrastate businesses. That is all the dormant Commerce clause requires

here, given the status of those bonds beyond their borders. *Bonaparte*, 104 U.S. at 595; *Georgia* v. *Chattanooga*, 264 U.S. 472, 480-81 (1924).

Finally, the Respondents tout the virtues of their position as imposing some form of fiscal discipline upon the states. They assert that "[o]nce states compete in the financial markets without the protective benefit of coercive tax schemes, they will have to be more selective in what projects they choose to fund," since "[t]hey will [be] compet[ing] for investors' dollars not just with respect to the interest rate offered, but on the merits of the projects funded by the investment sales." This theory is completely antithetical to the status of the states under the Constitution as autonomous and independent sovereign entities. *Alden* v. *Maine*, 527 U.S. 706, 713-15 (1999); *New York* v. *United States*, 505 U.S. 144, 162-63 (1992); *Erie R. Co.* v. *Tompkins*, 304 U.S. 64, 78-79 (1938). The states vary considerably in the needs and problems they and their citizens face and these needs and problems can change over time and even suddenly, such as in the event of a natural disaster or economic dislocation. "[O]ne of the happy incidents of the federal system [is] that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the county." *New State Ice Co.* v. *Liebmann*, 285 U.S. 262, 311 (1932)(Brandeis, J., dissenting). The states may therefore undertake projects or programs that may not necessarily be highly regarded by the financial markets at the time of their adoption. These projects and programs may be "experiments" that stand the test of time and experience, however, and ultimately prove worthy of emulation by other states and their local governments or even by the National Government. Such is a large part of the nature and genius of the federal system established by the Constitution.

These programs and projects may also be devoted to purposes and values that transcend any value that may be placed upon them by the financial markets - - e.g., the rebuilding of the infrastructure of a city stricken by natural disaster, the establishment of war memorials, the erection of courthouses and other public buildings. The states and their political subdivisions should not be forced into competition with other states, as the Respondents contend, in appealing to their taxpayers for the funding of those programs and projects. "In Chief Justice Chase's much-quoted words, 'the preservation of the States, and the maintenance of their governments, are as much within the design and care of the Constitution as the preservation of the Union and the maintenance of the National government. The Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States.'" *New York* v. *United States*, 505 U.S. at 162 (quoting *Texas* v. *White*, 7 Wall. 700, 725, 19 L.Ed. 227 (1869)). The Respondents' position is at odds with this fundamental principle. Their position would deny the states an important means of meeting their financial needs and instead pit the states against each other for the funding they need.

As sovereign entities under our federal system of government, the states must necessarily have the flexibility to order their fiscal affairs as they see fit to meet the challenges they face. One of the means by which the states can finance public projects and programs to address these challenges is to appeal to their taxpayers for loans of the necessary funds, employing the inducement of a tax exemption. As we have seen, this is a widespread practice that lowers the cost of borrowing for the many state and local governments that employ it. Pet. 7-11; Amicus Br. 6-7, 8-10. The Respondents may have policy arguments and studies that inveigh against this practice, but these policy arguments and studies have obviously not carried the day in the vast majority of the states. Pet 7-8. In the final analysis, under the Constitu-

tion it is the prerogative of the states as sovereign entities to decide for themselves the approach to take.

CONCLUSION

For the foregoing reasons and those stated previously, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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No. 06-666

IN THE
Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY, ET AL.,

Petitioners,

v.

GEORGE W. DAVIS AND KATHERINE V. DAVIS,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS OF KENTUCKY

MOTION FOR LEAVE TO FILE AND BRIEF OF THE NATIONAL ASSOCIATION OF STATE TREASURERS AS AMICUS CURIAE SUPPORTING PETITIONERS

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January 2007

IN THE

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No. 06-666

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY, ET AL.,

Petitioners,

v.

GEORGE W. DAVIS AND KATHERINE V. DAVIS,

Respondents.

MOTION OF THE NATIONAL ASSOCIATION OF STATE TREASURERS FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE

The National Association of State Treasurers ("NAST") hereby seeks leave, pursuant to this Court's Rule 37.2, to file the attached brief as an amicus curiae in support of Petitioners, Department of Revenue of the Commonwealth of Kentucky and Finance and Administration Cabinet of the Commonwealth of Kentucky. Petitioners have consented to the filing of this brief, but Respondents have declined to grant their consent. Correspondence reflecting the parties' respective positions has been lodged with the Clerk.

NAST is a nonprofit association, established in 1976, that is qualified as an exempt organization under Section 501(c)(6) of the Internal Revenue Code of 1986. NAST's members include the Treasurers or similar State financial officers of all 50 States, the District of Columbia, the Commonwealth of Puerto Rico, and several territories

of the United States. These officials typically function as the chief financial officers of their respective States with primary responsibility for a wide range of fiscal functions, including, in most cases, the State's direct debt issuance and other capital market operations. Many of these officials are also responsible for approving, or have other oversight responsibility for, the debt issuance and general fiscal affairs of political subdivisions and other public bodies within their respective States. NAST's membership also includes corporate affiliate members that provide accounting, financial, legal, or other advisory services to NAST's public members. In view of the role and responsibilities of NAST's public members in the issuance of public debt by States and their subdivisions, NAST has a strong interest in the constitutional question presented by the Petition regarding the treatment of municipal bonds under state tax laws.

NAST's affiliate organizations include the State Debt Management Network, the professional network of public sector employees who are responsible for the management and issuance of state debt, and the College Savings Plans Network, the professional network of public sector employees who are responsible for the management and supervision of qualified tuition programs.

NAST and its affiliate organizations have a long history of conducting extensive professional education programs, of engaging in the development and implementation of best practices, and of participating in the development of federal laws and administrative regulations affecting State fiscal affairs. NAST believes that its members' extensive experience in the field of municipal bonds and similar public programs will assist the Court in evaluating the importance of the issue presented by the Petition.

Accordingly, NAST respectfully seeks the Court's leave to file the attached brief supporting Petitioners.

Respectfully submitted.

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January 2007

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INTEREST OF AMICUS CURIAE

The National Association of State Treasurers ("NAST") is a nonprofit association, established in 1976, that is qualified as an exempt organization under Section 501(c)(6) of the Internal Revenue Code of 1986.[1] NAST's members include the Treasurers or similar State financial officers of all 50 States, the District of Columbia, the Commonwealth of Puerto Rico, and several territories of the United States. These officials typically function as the chief financial officers of their respective States with primary responsibility for a wide range of fiscal functions, including, in most cases, the State's direct debt issuance and other capital market operations. Many of these officials are also responsible for approving, or have other oversight responsibility for, the debt issuance and general fiscal affairs of political subdivisions and other public bodies within their respective States. NAST's membership also includes corporate affiliate members that provide accounting, financial, legal, or other advisory services to NAST's public members. In view of the role and responsibilities of NAST's public members in the issuance of public debt by States and their subdivisions, NAST has a strong interest in the constitutional question presented by the Petition regarding the treatment of municipal bonds under State tax laws.

NAST's affiliate organizations include the State Debt Management Network, the professional network of

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[1] Petitioners have consented to filing of this brief, while Respondents have declined to consent. Letters reflecting the parties' respective positions have been filed with the Clerk. Pursuant to this Court's Rule 37.6, NAST states that no counsel for a party authored this brief in whole or in part. Nor did any person or entity, other than NAST, its members, or its counsel make a monetary contribution to the preparation or submission of this brief.

public sector employees who are responsible for the management and issuance of state debt, and the College Savings Plans Network, the professional network of public sector employees who are responsible for the management and supervision of qualified tuition programs.

NAST and its affiliate organizations have a long history of conducting extensive professional education programs, of engaging in the development and implementation of best practices, and of participating in the development of federal laws and administrative regulations affecting State fiscal affairs. NAST believes that its members' extensive experience in the field of municipal bonds and similar public programs will assist the Court in evaluating the importance of the issue presented by the Petition.

STATEMENT

Two Kentucky taxpayers filed this action in the Circuit Court of Jefferson County, Kentucky challenging the Commonwealth's taxation of out-of-state municipal bonds. The Commonwealth of Kentucky, like a majority of the States, does not tax interest earned on bonds issued by the Commonwealth or its subdivisions, but it does tax interest earned on bonds issued by other States or their subdivisions. *See* Ky. Rev. Stat. Ann. § 141.010(9), (10).

The trial court granted Petitioners' motion for summary judgment. Pet. App. A15-A19. The court held that municipal bonds fall within the "market participant" exception to this Court's dormant Commerce Clause jurisprudence. *See, e.g., Reeves, Inc.* v. *Stake*, 447 U.S. 429 (1980); *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794 (1976). Accordingly, the court held, the State "clearly may pay a higher rate of interest to resident purchasers based upon the theories of distributing state created benefits and market participation." Pet. App. A18. The court observed that "[e]ach state has a legitimate interest

in drawing upon a major source of tax revenue while creating an incentive for investors to purchase state bonds." *Id.* at A19. Because Kentucky's taxation of out-of-state bonds has a "reasonable, legitimate public purpose," the court held that it is constitutionally permissible. *Id.*[2]

On appeal, the Kentucky Court of Appeals vacated and remanded the trial court's decision. Pet. App. A1-A13. The Court of Appeals held that Kentucky's tax on the income derived from bonds issued by States other than Kentucky is "facially unconstitutional" because "it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." *Id.* at A6.

The court rejected three arguments made by Petitioners in support of the constitutionality of Kentucky's tax code. *First*, the court declined to follow a decision of an Ohio appellate court holding that a similar taxation system does not violate the Commerce Clause. *See Shaper* v. *Tracy*, 647 N.E.2d 550 (Ohio Ct. App. 1994); Pet App. A7-A8. *Second*, the court held that this Court's decision in *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881), is not on point. *Bonaparte* involved a challenge to taxation of out-of-state bond interest based on the Full Faith and Credit Clause, and the Court there concluded that "no provision of the Constitution of the United States . . . prohibit[ed] such taxation." *Id.* at 594. The Kentucky Court of Appeals held that *Bonaparte* was not on point because it did not involve the Commerce Clause. Pet.

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[2] In addition, the court found that Respondents, as individuals, lack standing to challenge parallel provisions of Kentucky law taxing corporations, trusts, and estates on income from out-of-state bonds. Pet. App. A17. The court held, however, that Respondents have standing to challenge "an individual income tax paid by them." *Id.* at A18.

App. A9. *Third*, the court rejected Petitioners' "market participant" argument. The court found that issuing bonds constitutes participation in the bond market, while taxing income derived from bonds is an activity of the State as a market regulator. Because "the sole issue is Kentucky's decision to tax only extraterritorial bonds," the court found that "the market participant theory is inapplicable." *Id.* at A10.[3]

The Supreme Court of Kentucky denied discretionary review of the Court of Appeals' decision. *Id.* at A14.

SUMMARY OF THE ARGUMENT

Although NAST takes no position on the merits of the question presented, it strongly urges the Court to grant review. State and local governments rely on municipal bonds as an essential source of funding for a wide range of public projects and programs that benefit education, transportation, health, housing, and public utilities.

The principal feature of municipal bonds that distinguishes them from other capital market securities is their exemption from federal – and, in many cases, State and local – taxation. The tax-exempt status of municipal bonds allows State and local governments to borrow funds at a lower interest rate. Exempting municipal bonds from State and local taxes makes them even more attractive to investors. The importance of State tax exemptions is demonstrated by the popularity of mutual funds that invest in the municipal bonds of a single State.

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[3] The court also reversed the lower court's ruling on standing, concluding that "the trial court had confused the concept of standing with the somewhat related issues involved in class certification." Pet. App. A11. The court of appeals held that Respondents "have standing." *Id.* at A12.

The decision of the Kentucky court of appeals calls into question the tax treatment of municipal bonds in more than 40 States that grant a tax exemption for some or all in-State bonds but not for out-of-State bonds. In view of the vital importance of municipal bonds to State and local governments, and the centrality of their tax exempt status, this is an important question that should be decided promptly by this Court.

REASONS THE PETITION SHOULD BE GRANTED

NAST has not taken a position on the merits of the question presented by the Petition. Nevertheless, NAST strongly urges the Court to grant review in this case. The issue presented is very important to State and local government entities that issue municipal bonds and to citizens who benefit from government projects and activities financed by municipal bonds. The decision of the court below has created legal uncertainty that should be resolved promptly, and can only be resolved by this Court. Accordingly, the Petition should be granted.

I. Municipal Bonds Are An Essential Source Of Funding For State And Local Governments.

Municipal bonds are interest-bearing debt obligations issued by State or local government entities. These entities include the States themselves, State-created authorities, incorporated local municipalities and local authorities.[4] A municipal bond represents a promise

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[4] Bond-issuing entities include, in addition to States and their political subdivisions, public authorities established by specific authorizing legislation or interstate compacts (in the case of interstate agencies approved by Congress such as the Port Authority of New York and New Jersey, Joint Resolution of Aug. 23, 1921, 42 Stat. 174), as well as certain entities established under general law for the benefit of a State or political subdivision.

by the issuer to repay the investor the principal amount of the bond and interest according to a fixed schedule.

The most common category of public debt instruments are "general obligation" bonds, which are backed by the full faith and credit of the issuer to apply all sources of revenue, unless specifically limited, to payment of principal and interest. *See* The Bond Market Association, The Fundamentals of Municipal Bonds, 55-56 (5th ed. 2001). "Revenue bonds" generally are backed by a particular stream of revenue rather than general tax revenues. *Id.* at 58. Revenue bonds typically are used to fund specific projects that the issuer expects will generate revenue to service the debt. *See id.* For example, bonds issued to raise money for an airport or toll road may be funded by airport fees or tolls.[5]

State and local governments issue municipal bonds to raise funds to support general government needs or to fund public works projects and programs. Governments fund a wide range of capital projects through municipal bonds, including educational buildings at all levels from elementary schools to colleges and universities, government buildings, transportation facilities (including bridges, highways, and airports), public utility projects, hospitals, stadiums, and low-income housing.

State and local governments increasingly have come to rely on the issuance of municipal bonds to raise revenues for a wide range of vital projects, and State and local government credit has long been recognized as "an essential source of funding" for those entities. *South Carolina* v. *Baker*, 485 U.S. 505, 531 (1988) (O'Connor, J.,

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[5] A third category of municipal bonds, "moral obligation" bonds, are payable from revenues expected to be provided by the issuer or another government entity that is not legally obligated to make such payments. *Id.* at 57.

dissenting). *See also* Pet. 8 (noting that State and local governments "rely heavily upon the issuance of debt"). In the 25 years from 1975 through 1999, the total value of new short- and long-term municipal bonds issued grew tenfold, from $26 billion in 1975 to $263 billion in 1999. The Bond Market Association, *supra* at 3. More than $350 billion of long-term public finance debt was issued by States in each year from 2002 through 2006.[6]

The total value of outstanding municipal bonds has increased as well. In 1980, the total outstanding value of municipal bonds was approximately $399 billion; by 2000, that number had nearly quadrupled, to $1.5 trillion. *Id.* at 17. State and local governments' debt obligations have continued to rise: The Census Bureau's annual survey of State and local government finances reported a combined $1.68 trillion in outstanding debt in 2001-02, $1.81 trillion in 2002-03, and $1.95 trillion in 2003-04.[7] The steady increase in municipal bond issues reflects the critical importance of this source of funding for State and local capital programs affecting health, education and public improvements.

Municipal bonds offer benefits to the issuing authority, its citizen constituents, and the purchasers of the bonds. The bond issuer is able to fund important but expensive public projects, and may be able to do so without having to raise taxes. Citizens enjoy the benefits of projects financed through municipal bonds, which may be repaid over time with tax revenues or revenues generated by the project itself. And purchasers of

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[6] *The Bond Buyer/Thomson Financial Yearbook* 14-15 (2006); Matthew Hanson, *Volume in '06 a Near Record*, The Bond Buyer, January 2, 2007, at 1.

[7] U.S. Census Bureau, State and Local Government Finances, 2001-02 (Census); 2002-03; 2003-04, *all available at http://www.census.gov/govs/www/estimate.html.*

municipal bonds benefit from a reasonably safe investment. Although the pre-tax rate of return on municipal bonds is frequently lower than is available through other investment vehicles, that difference is offset by the tax-advantaged status of municipal bonds.

II. The Tax-Exempt Status Of Municipal Bonds Is Critical To Their Success.

The most distinctive feature of municipal bonds is their favorable tax treatment, which provides them with an advantage over other types of investments. This favorable tax treatment allows issuers of municipal bonds to obtain funding for public projects at a lower interest rate than would otherwise be available to them. Federal law provides a significant tax advantage by exempting interest on municipal bonds from federal income tax. Many States also exempt municipal bonds from State (and in some instances local) taxation. The State and local tax exemptions can provide a significant additional advantage to municipal bonds as compared to other investments.

A. Tax Exemptions Make Municipal Bonds More Attractive To Investors, And Reduce State And Local Governments' Cost Of Borrowing.

Exemption from federal taxation is the principal characteristic that has long distinguished public finance debt from all other capital market securities. *See* Robert S. Amdursky & Clayton P. Gillette, *Municipal Debt Finance Law Theory and Practice* § 1.3.4 (1992); The Bond Market Association, *supra* at 27-29. Since the Sixteenth Amendment was ratified in 1913, the Internal Revenue Code generally has accorded tax-free status to municipal bonds. The Bond Market Association, *supra* at 27. *See*

also 26 U.S.C. §§ 103, 141-150.[8] The tax-free status of municipal bonds allows the bond issuer to borrow money at a lower interest rate than it could obtain from other sources of financing. Investors are willing to accept lower interest rates precisely because of the advantages they gain from the tax exemption. *Id.*

The benefits of the tax exemption are readily calculable. It is misleading to compare the published interest rate of a municipal bond to that of an investment without favorable tax treatment, because taxes on non-exempt bonds reduce the after-tax return to the bondholder. To meaningfully compare the rate of return of a tax-free bond to that of a taxable bond, investors use the following formula to calculate the rate of return on a taxable bond that will yield the same income as a tax-free bond:[9]

$$\frac{\text{municipal bond yield}}{(1 - \text{marginal tax rate})} = \text{comparable taxable bond rate}$$

For example, a bondholder with a 33 percent marginal federal tax rate in a State without income tax, who purchases a municipal bond paying 5 percent interest per

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[8] The Securities Act of 1933 includes an exception to its registration requirements for securities issued by a State or political subdivision. *See* 15 U.S.C. § 77c(a)(2). The exemption was intended to "correspond[] generally with the line drawn by the courts as to what obligations of States, their units and instrumentalities created by them, are exempted from Federal taxation." H.R. Rep. No. 73-85, at 14 (1933). *See generally* Robert A. Fippinger, *The Securities Law of Public Finance*, §§ 2.2, 2.9.5 (2d ed. 1999).

[9] *See* The Bond Market Association, *supra*, at 28-29; Fidelity.com: Taxable vs. Municipal Bond Funds, *http://personal.fidelity.com/products/funds/content/fundtypes.shtml.cvsr?refpr=ipmf4*.

year will earn interest equivalent to a taxable bond that pays approximately 7.5 percent interest.[10]

B. The Benefits Of Favorable Tax Treatment Include Exemption From State And Local Taxation.

In comparing municipal bonds to other investments, taxpayers take into account not only the federal taxes that would be due on the income, but also State and local taxes. Many States exempt interest on their municipal bonds from taxation, and a State's ability to tax out-of-state bonds can have a significant impact on an investor's decision to purchase in-state bonds versus out-of-state bonds. The "essential variable" in computing the equivalent yield between taxed and tax-free bonds is the investor's marginal tax rate. The Bond Market Association, *supra* at 27. An investor who resides in a State with an income tax who purchases bonds that are free from State taxation as well as federal taxation increases his or her equivalent taxable yield. The greater the investor's marginal tax rate, the greater the advantage of municipal bonds over other investments. *Id.*[11]

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[10] That is so because $0.05 \div (1 - 0.33) = 0.0746$.

[11] State and local income tax payments generally are deductible from income under federal law, so the taxpayer's marginal tax rate is not simply the sum of her federal tax bracket and the State tax rate. *See* The Bond Market Association, *supra*, at 29. Instead, the marginal tax rate for persons who itemize is calculated according to the following formula:

federal bracket + state rate – (federal bracket x state rate)

A taxpayer in the 33 percent federal tax bracket whose State imposes a 5 percent income tax would thus have a combined marginal rate on a fully taxable investment of 0.33 + 0.05 – (0.33 * 0.05), or 36.35%. *See id.*

Favorable State tax treatment of municipal bonds increases the marketability of municipal bonds, and exemptions from State and local taxation may be particularly important to smaller issuers and those with less than perfect credit ratings.[12] Investors have increasingly sought bonds that are exempt from State (and in some cases local) taxation, and mutual fund managers have created State-specific bond funds to meet that demand. *See* Jerry Webman, *Managing Single-State Municipal Bond Funds* in The Handbook of Municipal Bonds 339-350 (Susan C. Heide, Robert A. Klein & Jess Lederman eds., 1994).[13] The popularity of State-specific bond funds demonstrates that investors view exemption from state taxation as an important consideration when investing in municipal bonds.[14]

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[12] *See* Robert Lamb & Stephen P. Rappaport, *Municipal Bonds* 2, 25-26 (2d ed. 1987); Dwight Denison, *Bond Market Reactions to Hurricane Katrina: An Investigation of Prices and Trading Activity of New Orleans Bonds*, Municipal Finance Journal 39-52 (2006).

[13] *See also, e.g.*, Vanguard California Tax-Exempt Money Market Fund (Symbol: VCTXX); Vanguard Florida Long-Term Tax-Exempt Fund Investor Shares (Symbol: VFLTX); Vanguard Pennsylvania Long-Term Tax-Exempt Fund Investor Shares (Symbol: VPAIX). Each of these funds seeks to provide income that is exempt from federal income tax and tax in the bond issuing state, and is intended for residents of that state. Similar funds are targeted to residents of Alabama, Arizona, Connecticut, Delaware, Kentucky, Massachusetts, Michigan, Minnesota, Ohio, Oregon, New York, North Carolina, Rhode Island, Virginia, and others. *See, e.g.*, Funds by Name, *https://flagship.vanguard.com/VGApp/hnw/FundsByName*; State Municipal Bond Funds, *http://personal.fidelity.com*; funds available through Charles Schwab, *http://www.schwab.com*.

[14] Between 1980 and 1999, the percentage of municipal bonds held by mutual funds increased twenty-fold, from 1.6% of (...continued)

III. The Proper Tax Treatment Of Interest On Municipal Bonds Is An Important Question That Should Be Decided By This Court.

The Kentucky Court of Appeals held that the federal Constitution prohibits a State from exempting interest earned on in-State municipal bonds from State taxation unless it provides an equivalent exemption for interest earned on out-of-State bonds. *See* Pet. App. A10. The Kentucky Supreme Court has declined to review that decision. *Id.* at A14. The Kentucky court's ruling calls into question the tax treatment of municipal bonds in some 42 States that grant an exemption for some or all in-State bonds but not for out-of-State bonds. *See* Pet. 7-8; The Bond Market Association, *supra* at 30-31. In view of the vital importance of municipal bonds to State and local governments, and the centrality of their tax exempt status, this is plainly an important issue that merits this Court's consideration.

The Kentucky Court of Appeals' decision is squarely in conflict with the decision of the Ohio Court of Appeals in *Shaper* v. *Tracy*, 647 N.E. 2d 550 (1994), which holds that the Commerce Clause does not require States that exempt interest on in-State municipal bonds to grant a similar exemption for out-of-State municipal bonds. The conflict in the lower court decisions creates legal uncertainty that should be resolved without delay. Because the Kentucky Supreme Court has declined to review the decision in this case, only this Court can resolve the uncertainty created by the Kentucky court's decision. [15]

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outstanding bonds in 1980 to 33.7% in 1999. The Bond Market Association, *supra*, at 17.

[15] The decision of the Kentucky Court of Appeals is likely to spur additional litigation on this issue in other States. (...continued)

The Court should decide the question presented by the Petition now rather than awaiting a later case. The issue is squarely presented by this case, and the prior decisions of this Court provide an adequate basis for deciding it. Moreover, municipal bond markets will function most efficiently if the legal uncertainty created by the Kentucky court's decision is resolved promptly.

As a result of the Kentucky court's decision, Kentucky is the only State that is prohibited from exempting interest on in-State municipal bonds unless it grants an equivalent exemption to out-of-State bonds. As noted in the Petition, the States have chosen a variety of approaches to the taxation of out-of-State bonds. While a few States have structured their income tax to exempt income from both in-State and out-of-State bond interest, the majority have adopted an approach that is similar or identical to that of Kentucky. The Bond Market Association, *supra* at 30-31. Regardless of the merits of the question presented, the federal Constitution should apply uniformly to all 50 States.

Indeed, additional litigation is already pending. *See Dunn* v. *Cook*, 635 S.E.2d 604 (N.C. App. 2006) (affirming the certification of a class of taxpayers in order to challenge state income tax on interest earned on municipal bond obligations of States other than North Carolina).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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January 2007

-4

19

No. 06-666

FILED
JUL 19 2007
OFFICE OF THE CLERK
SUPREME COURT, U.S.

In The Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY and FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,

Petitioners,

v.

GEORGE W. DAVIS and CATHERINE V. DAVIS,

Respondents.

On Writ Of Certiorari To The Court Of Appeals Of Kentucky

JOINT APPENDIX

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Petition For Certiorari Filed November 9, 2006
Certiorari Granted May 21, 2007

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The following opinions and orders have been omitted in printing this Joint Appendix because they appear on the following pages in the appendix to the Petition for Certiorari:

Jefferson Circuit Court's Order Granting Summary Judgment ..... Pet. App. A15

Opinion of the Court of Appeals of Kentucky, *Davis v. Department of Revenue*, 193 S.W.3d 557 (Ky. App. 2006) ..... Pet. App. A1

Order of the Supreme Court of Kentucky Denying Motion for Discretionary Review ..... Pet. App. A14

RELEVANT DOCKET ENTRIES

Circuit Court, Division I
Jefferson County, Commonwealth of Kentucky

Civil Action No. 03-CI-03282

George W. Davis, et al.,
Plaintiffs
vs.
Revenue Cabinet, Commonwealth of Kentucky, et al.,
Defendants

04/11/2003	Case Filed CONTRACT *JURY FEE NOT PAID*
04/11/2003	Document Filed COMPLAINT/PETITION AP
	* * *
05/05/2003	Document Filed ANSWER D *REVENUE CABINET*
	* * *
07/17/2003	Document Filed ORDER SETTING TRIAL/HEARING JUD *ORAL ARGUMENTS 9-29-03 @1:30*
	* * *
07/18/2003	Motion Filed MOTION FOR SUMMARY JUDGMENT ATTORNEY FOR DEFENDANT (CIVIL) *DEFT'S. . . . MEMO IN SUPPORT NO ORD. TEND.*

08/22/2003 Document Filed
MISCELLANEOUS
AP
PLTFS' OPPOSITION TO DEFTS' MOT. FOR SUM.JUDGMENT.

* * *

09/03/2003 Document Filed
MISCELLANEOUS
AP
PLTFS' OPPOSITION TO DEFTS' MOTION FOR SUM.JUDGMENT. BINDER I & II.

* * *

09/08/2003 Document Filed
ORDER FOR APPEARANCE PRO HAC VICE
TAMMY MCCLENDON STOKES AND DAVID J. GUINN ON BEHALF OF PLAINTIFFS, GEORGE W. DAVIS AND CATHERINE V. DAVIS

* * *

09/08/2003 Document Filed
ORDER FOR APPEARANCE PRO HAC VICE
M. SCOTT BARRETT, DONN H. WRAY, JOHN R. WYLIE, HART L. ROBINVITCH ON BEHALF OF PLAINTIFFS GEORGE W. DAVIS AND CATHERINE V. DAVIS

* * *

09/12/2003 Document Filed
REPLY
AD
DEFTS' . . . . TO PLTFS' OPPOSITION TO DEFTS' MOT. FOR SUM.JUDGMENT

* * *

09/29/2003 Scheduled Event Sep 29 2003 at 1:30 PM
ORAL ARGUMENTS
HON. BARRY WILLETT

10/17/2003 Document Filed
MISCELLANEOUS
AD
DEFT'S CONFIRMATION OF EXHIBIT OFFERED AT HEARING O[N] MOT. FOR SUM.JUDGMENT.

11/06/2003 Motion Filed
MOTION – OTHER
ATTORNEY FOR PLAINTIFF
PLTFS'. . . . COURT TO ENTER ORDER THAT CONFIRMATION OF RECEIPT OF 4/10/03. ORD. TEND.

* * *

11/10/2003 Document Filed
ORDER – OTHER
LETTERS OF 041003 ATTACHED TO PLAINTIFF'S MO. FOR ENTRY OF THIS ORDER REQ. INCOME TAX REFUND ON BEHALF OF PLAINTIFFS AND OTHERS SIMILARLY SITUATED OFFERED INTO EVIDENCE 041003, HEREBY MADE PART

04/15/2004 Motion Filed
MOTION TO FILE
ATTORNEY FOR PLAINTIFF
PLTFS'. . . . SUPPLEMENTAL AUTHORITY IN OPPOSITION TO DEFTS' MOT. FOR S.J. ORD. TEND.

* * *

04/20/2004 Document Filed
ORDER – OTHER
PLAINTIFF'S REQ. TO FILE SUPP. AUTH. IN OPP. TO DEF'S MO. FOR SJ IS SUSTAINED. COURT MAY IN ITS DELIBERATION WITH RESPECT TO SJ MO. CONSIDER SUCH AUTH. AND THE ARGUMENT OF PLAINTIFF'S COUNSEL

04/20/2004 NOE to All Counsel of Record and Parties Not Represented by Counsel.
ORDER – OTHER
FIRST CLASS MAIL
PLAINTIFF'S REQ. TO FILE SUPP. AUTH. IN OPP. TO DEF'S MO. FOR SJ IS SUSTAINED. COURT MAY IN ITS DELIBERATION WITH RESPECT TO SJ MO. CONSIDER SUCH AUTH. AND THE ARGUMENT OF PLAINTIFF'S COUNSEL

05/03/2004 Document Filed
RESPONSE
AD
DEFTS' . . . . TO PLTFS' SUPPLEMENTAL AUTHORITY.

08/30/2004 Case Disposed 507 Days
SUMMARY JUDGMENT
JURY FEE NOT PAID

08/30/2004 Document Filed
ORDER GRANTING
JUD
DEFENDANT'S MOTION FOR SJ

* * *

09/21/2004 Document Filed
NOTICE OF APPEAL
AP
$125.00 FEE PAID. COPIES MAILED TO: GEORGE M. GEOGHEGAN, III, CLERK, A. RALUY, M. BARRETT, D. TRAINOR, D. WRAY, H. ROBINOVITCH, C. WATKINS, J. WYLIE, M. DAMPIER, D. GUIN AND T. STOKES

* * *

12/14/2004 Document Filed
NOTICE OF CERTIFICATION OF RECORD ON APPEAL
CASE CRETIFIED [sic] *AND COPIES MAILED TO GEORGE M. GEOGHEGAN, III, CLERK AND TO IRVIN D. FOLEY DAVID W. GRAY, DOUG DOWELL, DEBRA KEELEN AND SEE INDEX CARD FOR THE REST OF ATTORNEYS.*

* * *

COURT OF APPEALS OF KENTUCKY
Appeal No. 2004-CA-001940-MR

#	Date	Description	Memo
1	08/30/2004	CIRCUIT COURT JUDGMENT: **JD**	
2	09/21/2004	NOTICE OF APPEAL – REGULAR CIVIL: **AI**	** FILING FEE PAID **Due Date: (10/11/2004)**
3	10/07/2004	PREHEARING STATEMENT: **HE**	**Due Date: 10/18/2004)**
		* * *	
7	10/22/2004	PREHEARING CONF SCHED DATE TIME LOCATION: **CS**	PREHEARING CONFERENCE 11/12/04 2:30 LOUISVILLE P.S.
8	11/15/2004	PREHEARING CONF RESULT (NO SETTLEMENT): **RC**	
9	11/15/2004	ORDER ENTERED TO START: **ST**	PREHEARING CONFERENCE ORDER – TIME FOR ALL FURTHER STEPS, SUBSEQUENT TO THE NOTICE OF APPEAL, SHALL COMMENCE TO [R]UN FROM THE ENTRY OF THIS ORDER, EXCEPT AS STATED BELOW: 1) THE APPELLANTS SHALL FILE THEIR BRIEF

			WITHIN SIXTY (60) DAYS FROM THE DATE THE RECORD IS CERTIFIED. (2) THE APPELLEES SHALL FILE ITS BRIEF WITHIN SIXTY (60) DAYS FROM THE DATE THE APPELLANT' BRIEF IS FILED. (3) THE APPELLANTS SHALL FILE THEIR REPLY BRIEF WITHIN FIFTEEN (15) DAYS FROM THE DATE THE APPELLEES' BRIEF IS FILED. **Due Date: (01/24/2005)**
10	12/14/2004	NOTIF. OF CERTIFICATION – REGULAR CIVIL: **NI**	**Due Date: (02/14/2005)**
11	02/14/2005	APPEAL PERFECTED: **AP**	**Due Date: (04/15/2005)**
12	04/05/2005	PROCEDURAL MOTION: **MP**	APPELLEE'S MOTION FOR ADDITIONAL TIME TO FILE BRIEF, UP TO AND INCLUDING MAY 16, 2005 **Due Date: (04/18/2005)**
		* * *	
14	04/21/2005	ORDER GRANTING PROCEDURAL MOTION: **OMPG**	COURT ORDER DELIVERED, GRANTING APPELLEE'S MOTION FOR ADDITIONAL TIME TO FILE BRIEF. APPELLEE'S BRIEF SHALL BE FILED ON

			OR BEFORE 5/16/05. **Due Date: (05/6/2005)**
15	05/13/2005	APPELLEE BRIEF FILED: **AB**	**Due Date: (05/31/2005)**
16	06/01/2005	PROCEDURAL MOTION: **MP**	APPELLANT'S MOTION FOR ADDITIONAL TIME TO FILE REPLY BRIEF, 30 DAYS, UP TO AND INCLUDING JULY 15, 2005. TIMELY MAILED REGISTERED MAIL 05-31-05. **Due Date: (06/13/2005)**
		* * *	
18	06/17/2005	ORDER GRANTING PROCEDURAL MOTION: **OMPG**	COURT ORDER DELIVERED, GRANTING APPELLANT'S MOTION FOR ADDITIONAL TIME TO FILE A REPLY BRIEF. BRIEF SHALL BE FILED ON OR BEFORE 6/30/05. **Due Date: (06/30/2005)**
19	07/01/2005	APPELLANT'S REPLY BRIEF:**RB**	FILED TIMELY PURSUANT TO CR.76.40 (2) – SENT REGISTERED MAIL ON 6/30/05.
20	07/01/2005	RECORD REQUEST FROM CIRCUIT COURT CLRK: **RR**	**Due Date: (08/01/2005)**

21	07/20/2005	RECORD FILED: **RF**	2 VOLUMES RECORD
22	07/22/2005	SUBMISSION: **R3**	
23	08/16/2005	APPEAL ASSIGNED ON THE MERITS: **SH1**	ASSIGNED MONTH: 12/2005 PRESIDING JUDGE: MINTON JOHN D. PANEL: 2. NOTE:
24	10/07/2005	ASSIGN/ SCHEDULE (DATE, TIME & LOCATION) **SH2**	DATE: 12/02/2005 TIME: 11:00 AM LOCATION: JEFFERSON COUNTY JUDICIAL CENTER, 10TH FLOOR APPELLATE COURTROOM, 700 WEST JEFFERSON, LOUISVILLE, KENTUCKY NOTE:
25	11/17/2005	PROCEDURAL MOTION: **MP**	IRVIN FOLEYS MOTION FOR JOHN WYLIE TO BE ADDED PRO HAC VICE COUNSEL FOR APPELLANTS. (1 COPY TO MZ, 2 COPIES TO JS) **Due Date: (11/28/2005)**
26	11/18/2005	RESPONSE TO MOTION: **ZZM**	APPELLEE'S RESPONSE TO IRVIN FOLEY'S MOTION FOR JOHN WYLIE TO BE ADDED PRO HAC VICE COUNSEL FOR APPELLANT'S. (1 COPY TO MZ)

* * *

28	12/01/2005	ORDER GRANTING PROCEDURAL MOTION: **OMPG**	COURT ORDER DELIVERED GRANTING MOTION BY IRVIN D. FOLEY TO ADMIT JOHN R. WYLIE TO PRACTICE PRO HAC VICE ON BEHALF OF APPELLANTS.
29	01/06/2006	OPINION – VACATING & REMANDING: **P6**	OPINION VACATING AND REMANDING MINTON BARBER (CONCURS) AND TAYLOR (CONCURS) TO BE PUBLISHED 16 PAGES

* * *

KENTUCKY SUPREME COURT

2006-SC-105

DATE	EVENT	DESCRIPTION
08/30/2004	JD	JUDGMENT/ORIGINAL ACTION DATE
02/02/2006	DI	MOTION FOR DISCRETIONARY REVIEW (CIVIL) NO FILING FEE REQUIRED; COURT OF APPEALS OPINION RENDERED JANUARY 6, 2006; P DUE DATE: 03/04/2006
03/07/2006	R5	READY – DISCRETIONARY REVIEW NO RESPONSE FILED.
03/07/2006	SH	SENT OUT FOR ASSIGNMENT
03/09/2006	BCLATE	COURTS OWN MOTION: LATE LETTER RECEIVED FROM RESPONDENTS "LATE" RESPONSE TO MOTION FOR DISCRETIONARY REVIEW – RETURNED WITH LATE LETTER – DUE 3/4/06 (MAILED BY REGISTERED MAIL 3-8-06)
03/16/2006	ML	MOTION AS TO ENLARGEMENT OF TIME RESPONDENTS FILED MOTION FOR ENLARGMENT OF TIME TO FILE RESPONSE TO MOTION FOR DISCRETIONARY REVIEW. (TENDERED RESPONSE TO MOTION FOR DISCRETIONARY REVIEW) ORDER STEP #8 DUE DATE: 03/27/2006

03/28/2006	MS	SCHEDULE TO MOTION DOCKET NO RESPONSE FILED MOTION STEP #6
03/28/2006	OL	ORDER – AS TO MOT. FOR ENLARGEMENT COURT ORDER DELIVERED GRANTING RESPONDENT'S MOTION FOR ENLARGMENT OF TIME TO FILE RESPONSE TO MOTION FOR DISCRETIONARY REVIEW, TENDERED RESPONSE IS ORDERED FILED. MOTION STEP #6
07/25/2006	CKREC	** NOTICE OF RECUSAL ** THIS COURT HAVING BEEN ADVISED THAT HON. JOHN D. MINTON, JR. WAS A SITTING JUDGE IN THIS ACTION IN THE LOWER COURT, NOTICE IS HEREBY GIVEN TO ALL PARTIES THAT HE WILL NOT BE PARTICIPATING IN THIS CASE.
08/17/2006	DD	ORDER DENYING DISCRETIONARY REVIEW
08/17/2006	FL	FINALITY

NO. 03 CI 03282 **JEFFERSON CIRCUIT COURT**
DIVISION ONE (1)

GEORGE W. DAVIS and CATHERINE V. DAVIS, 1321 Garden Hill Place, Louisville, KY 40205 Individually and on behalf of others similarly situated **PLAINTIFFS**

v.

COMMONWEALTH OF KENTUCKY REVENUE CABINET and COMMONWEALTH OF KENTUCKY FINANCE AND ADMINISTRATION CABINET **DEFENDANTS**

Serve: Hon. Dana Bynum Mayton, Secretary,
Revenue Cabinet
200 Fair Oaks Lane
Suite 316
Frankfort, Kentucky 40620

Serve: Hon. Gordon Duke, Secretary, Finance and
Administration Cabinet
Room 383 Capitol Annex
Frankfort, KY 40601

Serve: Hon. A.B. Chandler III
Attorney General of Kentucky
118 State Capitol Building
700 Capitol Avenue
Frankfort Kentucky 40601

CLASS ACTION COMPLAINT FOR DECLARATORY JUDGMENT, INJUNCTION and TAX REFUNDS

Plaintiffs, George W. Davis and Catherine V. Davis, for their Complaint against the Defendants, Commonwealth of Kentucky Revenue Cabinet and Commonwealth

of Kentucky Finance and Administration Cabinet, by counsel, state as follows:

INTRODUCTION

1. Plaintiffs seek declaratory and injunctive relief and damages on behalf of themselves and all others similarly situated. Plaintiffs challenge the constitutionality of that part of the Kentucky Income Tax ("KIT"), codified at KRS 141.010, which imposes a greater KIT on interest income derived from obligations of sister states and/or their political subdivisions than on interest income derived from obligations of the Commonwealth of Kentucky and its political subdivisions. As with other tax receipts, the Revenue Cabinet deposits the income taxes collected with the Commonwealth of Kentucky State Treasurer or a depositary designated by the Treasurer pursuant to KRS 41.070.

2. The Secretary of the Finance and Administration Cabinet is the chief financial officer of the State, KRS 42.010, and said Cabinet is charged with the duty to issue its warrant to the state Treasurer for payment of authorized claims upon the State Treasury, and under KRS 141.010 as hereinafter described is a proper party through which the State maybe sued to recover wrongfully collected income tax.

JURISDICTION AND VENUE

3. This Court has subject matter jurisdiction over this action pursuant to KRS 23A.010, KRS 418.040 and KRS 452.505 because:

a. It has original jurisdiction over all justiciable causes not vested in any other court and this cause is not so otherwise vested;

b. The amount in controversy exceeds the minimum jurisdictional prerequisite of this Court;

c. Plaintiffs seek a declaration of rights concerning a justiciable controversy;

d. This action is connected with the payment of revenues into the state treasury, and

e. A prima facie violation of the Commerce Clause of the United States Constitution, Art. I, Section 8, Clause 3, is alleged, and therefore Plaintiffs had no adequate administrative remedy.

4. This Court has personal jurisdiction over the Revenue Cabinet of the Commonwealth of Kentucky (the "Revenue Cabinet"), and over the Finance and Administration Cabinet of said Commonwealth in this action because each of said Cabinets is an administrative agency of this Commonwealth subject to suit. Venue is proper in this Court pursuant to KRS 452.405 and KRS 452.505; the cause of action arose in Jefferson County and the acts of the Defendants caused and continue to cause injury to the Plaintiffs in Jefferson County.

THE PARTIES

5. George W. Davis and Catherine V. Davis are individual residents of Jefferson County, Commonwealth of Kentucky.

6. Defendant Revenue Cabinet is an administrative agency within the Commonwealth with the power to administer and enforce all tax laws of the Commonwealth.

KRS 131.030(1). Said Defendant is responsible for receiving the income tax after collection, for depositing the amounts collected with the Commonwealth of Kentucky State Treasurer and for refunding any unconstitutional taxes (KRS 134.590). Administrative agencies such as the Revenue Cabinet are not qualified or equipped to render decisions on the constitutionality of statutes and may not, therefore, settle refund claims for unconstitutional taxes made under KRS 134.590.

7. Defendant Finance and Administration Cabinet is an administrative agency of the Commonwealth within the meaning of KRS 134.590 and together with Defendant Revenue Cabinet is under a duty to refund taxes paid under a statute held unconstitutional.

THE CONTROVERSY

8. Pursuant to KRS Chapter 141 an income tax is imposed on individuals, estates, trusts, fiduciaries,[1] and corporations. *See* KRS 141.020, 141.030, and 141.040.

9. In the case of taxpayers other than corporations, the starting point for computing income subject to KIT for the tax year (generally, the calendar year) is Gross Income as defined by Internal Revenue Code ("IRC") § 61.[2] IRC

---

[1] For estates and trusts, the computations of net or taxable income bases, as well as the rates of tax, are the same as those for individuals. KRS 141.030.

[2] IRC § 103 specifically provides that "gross income" within the meaning of IRC § 61 does not include interest on any "State or local bond" which is defined as "an obligation of a State or political subdivision thereof." IRC § 103(c)(1). (For purposes of § 103, the term "State" is defined to include the District of Columbia and any possession of the United States.)

§ 62 authorizes certain deductions in arriving at federal Adjusted Gross Income ("AGI"). KRS 141.020 and 141.030. Kentucky "Adjusted Gross Income" (Kentucky AGI"), in the case of taxpayers other than corporations, means gross income as defined in IRC § 61, minus the deductions allowed individuals by IRC § 62,[3] plus or minus the various additions and subtractions prescribed by KRS 141.010. The addition complained of herein is codified at KRS 141.010 (10)(c) which provides:

> "Adjusted gross income" in the case of taxpayers other than corporations means gross income as defined in subsection (9) of this section minus the deductions allowed individuals by Section 62 of the Internal Revenue Code [FN4] and as modified by KRS 141.0101 and adjusted as follows, except that deductions shall be limited to amounts allocable to income subject to taxation under the provisions of this chapter, and except that nothing in this chapter shall be construed to permit the same item to be deducted more than once:
>
> . . .
>
> (c) Include interest income derived from obligations of sister states and political subdivisions thereof[.]

KRS 141.010(10)(c),

Kentucky "net income" is the taxable income base upon which Kentucky income tax for non-corporate taxpayers is calculated. KRS 141.020 and 141 030.

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[3] KRS 141.0101 contains certain depreciation deduction modification rules that are not applicable to this case.

10. The computation of a corporation's income subject to KIT is its Gross Income as defined by IRC § 61, less the deductions allowed by Chapter 1 of the internal Revenue Code (the result being a corporation's federal taxable income), with many modifications thereto that increase or decrease federal taxable income to arrive at the amount of income subject to KIT. KRS 141.010, subds. (12)-(14). All of the modifications prescribed by the Kentucky Revised statutes are irrelevant to this case save for one. The addition complained of herein is codified at KRS 141.010(12)(c) which provides:

> (12) "Gross income," in the case of corporations, means "gross income" as defined in Section 61 of the Internal Revenue Code and as modified by KRS 141.0101 and adjusted as follows:
>
> . . .
>
> (c) Include interest income derived from obligations of sister states and political subdivisions thereof[.]

KRS 141.010(12)(c).

11. The additions required by KRS 141.010(10)(c) and (12)(c) confer upon the Commonwealth of Kentucky (and its political subdivisions) an advantage over its sister states (and their political subdivisions) by allowing Kentucky income taxpayers to exclude from KIT interest income derived from obligations of the Commonwealth of Kentucky and its political subdivisions while subjecting interest income derived from obligations of sister states and/or their political subdivisions to KIT.

12. By reason of the Commerce Clause (Article I, Section 8, Clause 3 of the United States Constitution), the

Commonwealth of Kentucky may not burden or discriminate against interstate commerce by subjecting interest on obligations of sister states and/or their political subdivisions to KIT, while exempting from income subject to KIT the interest on obligations of the Commonwealth and/or its political subdivisions. Such discrimination violates the Commerce Clause of the United States Constitution. The manner of assessment of the KIT violates the commerce Clause by providing a commercial advantage to obligations of the commonwealth of Kentucky and/or its political subdivisions at the expense of obligations issued by sister states and/or their political subdivisions. This tax scheme by its nature necessarily forecloses "tax neutral" purchase and/or sale decisions by Kentucky taxpayers. A Kentucky taxpayer (whether individual or corporate or otherwise) evaluating purchase of obligations of Kentucky (and/or its political subdivisions) and sister states (and/or their political subdivisions) can avoid or reduce KIT by buying obligations of Kentucky and/or its political subdivision, whereas such a taxpayer's income subject to KIT will be increased if the taxpayer invests or continues to hold obligations issued by sister states and/or their political subdivisions.

13. Defendants have implemented the aforementioned Kentucky Revised Statutes and have enforced, and will continue to enforce, the collection of the KIT in accordance with such statutes against the Plaintiffs and the members of the class or classes they propose to represent.

FACTS RELATING TO PLAINTIFFS' KIT TRANSACTIONS

A. Transactions Common to Multiple Plaintiffs

14. George W. Davis and Catherine V. Davis are individual residents of Jefferson County, Commonwealth of Kentucky. Plaintiffs are taxpayers who, in the course of paying their KIT, have paid KIT on interest income derived from obligations of sister states and/or their political subdivisions at various dates during the class period.

15. KRS 134.590(2) purports to require an application for refund as a condition precedent to refund of ad valorem taxes or taxes held unconstitutional, such application to be made within two (2) years from the time payment was made. The requirement is an exercise in futility because only a court may determine whether a statute or regulation is unconstitutional. An administrative agency such as the Revenue Cabinet cannot declare a statute unconstitutional.

16. Plaintiffs have filed a refund claims [sic] on behalf of themselves and all other similarly aggrieved taxpayers who paid the unconstitutional taxes at anytime during the class period.

CLASS ALLEGATIONS

17. Plaintiffs bring this action on behalf of themselves and as representatives of a class composed of all persons[4] who have paid KIT on interest income derived

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[4] The terms "person" or "persons" has the same meaning as that contained in the Internal Revenue Code of 1986. Thus the terms mean

(Continued on following page)

from obligations of sister states and/or their political subdivisions at any time during the class period, and all such persons who hereafter during all time periods for which the relief prayed for herein may be granted shall pay KIT on interest income derived from obligations of sister states and/or their political subdivisions.

18. The plaintiff Class consists of all persons (whether natural or artificial) who satisfy each of the following criteria:

a. At any time during the class period;

b. They included in their Kentucky taxable income interest income derived from obligations of sister states and/or their political subdivisions; and

c. They paid Kentucky Income Tax on interest income derived from obligations of sister states and/or their political subdivisions, or paid more Kentucky income tax, or received a lesser income tax credit, than they would have had such interest income been excluded from their Kentucky taxable income.

19. The Class period is four years, or in the alternative (if KRS 134.580 – allowing a four year claim period is held inapplicable), two years.

20. If relief is granted pursuant to KRS 134.590, Plaintiffs are entitled to refunds of the KIT paid if such tax is held to have been paid pursuant to an unconstitutional statutory scheme provided application for the

---

and include an individual, a trust, estate, partnership, association, company or corporation. *See* 26 U.S.C. § 7701(a)(1).

refund is made within two (2) years after payment was made. Pursuant to KRS 134.580, however, a refund of taxes other than ad valorem and unconstitutional taxes may be made if application for the refund is made to the Revenue Cabinet within four (4) years after payment was made. This distinction violates Plaintiffs' rights of equal protection granted under the Fourteenth Amendment of the United States Constitution and under Sections 3 and 59 of the Kentucky Constitution.

21. The members of the class are so numerous that joinder of all members is impractical.

22. Plaintiffs' claims are typical of the claims of the members of the Class. All Plaintiffs were victimized by the Defendants' unconstitutional scheme to extract illegal taxes under duress.

23. There are numerous questions of law and fact which are common to the class and which predominate over any questions affecting individual members of the Class, including:

- Whether the plaintiffs are entitled to tax refunds;
- Whether the plaintiffs are entitled to interest on their tax refunds;
- Whether the additions required by KRS 141.010(10)(c) and (12)(c) violate the Commerce Clause of the United States Constitution (Article I, Section 8, Clause 3).
- Whether the 1996 amendments to KRS 134.590 that removed the "in each case" requirement allow taxpayers to maintain a class action for refunds of unconstitutional taxes without filing an application for refund "in each case."

- Whether the entire KIT, as applied to holders of obligations of obligations of sister states and/or their political subdivisions, is unconstitutional because the unconstitutional portion of the law is not severable.

- Whether the two year period under KRS 134.590 violates Plaintiffs' rights of equal protection granted under the Fourteenth Amendment of the United States Constitution and under Sections 3 and 59 of the Kentucky Constitution because KRS 134.580 allows for a longer (four years) period for refund claims.

24. Plaintiffs will fairly and adequately protect the interests of the members of the Class and have retained competent counsel experienced in class litigation. Plaintiffs are members of the class and do not have interests antagonistic to or in conflict with members of the Class. Neither Plaintiffs nor Plaintiffs' counsel have any interests which might cause them not to vigorously pursue their claims. Plaintiffs' claims are the same as those of the claims of the class, which all arise from the same operative facts and are based on the same legal theories.

25. A class action is superior to other available methods for the fair and efficient adjudication of this controversy since the membership of the Class is so numerous and so geographically widespread that joinder of all members is impracticable.

26. The prosecution of separate actions by individual members of the class would create a risk of adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interest of the other members not parties to the adjudications. Defendants have acted on grounds generally applicable to

all members of the class, thereby making appropriate final injunctive and corresponding declaratory relief with respect to the class as a whole.

CLAIMS

COUNT I

Unlawful Burden on Interstate Commerce

27. Plaintiffs incorporate the above allegations in this cause of action.

28. The KIT, as applied to interest income derived from obligations of sister states and/or their political subdivisions, constitutes an unlawful burden on interstate commerce in violation of the Commerce Clause of the United States Constitution, Article I, Section 8, Clause 3, because it treats interest income derived from obligations of sister states and/or their political subdivisions less favorably than the taxation of interest income derived from obligations of the Commonwealth of Kentucky and its political subdivisions. The statutory tax scheme thus discriminates on its face against the holders of obligations of sister states and/or their political subdivisions, such as Plaintiffs, by imposing a tax and corresponding burden on such interest income that is greater than that imposed on interest income derived from obligations of the Commonwealth of Kentucky and its political subdivisions.

COUNT II

Uniformity and Equal Protection

29. Plaintiffs incorporate the above allegations in this cause of action.

30. Section 171 of the Kentucky Constitution requires taxes to "be uniform upon all property of the same class subject to taxation . . . " Section 3 of the Kentucky Constitution and the Fourteenth Amendment to the United States Constitution grant equal protection of the laws to all persons. The KIT, as applied to the transactions complained of herein, violates these requirements because it does not tax in-state interest and out-of-state interest, otherwise similar in economic substance, at the same rate. Instead, it taxes the out-of- state interest at a higher rate than in-state interest.

COUNT III

The Entire KIT is Unconstitutional

31. Plaintiffs incorporate the above allegations in this cause of action.

32. If, as a practical matter, the admitted unconstitutional portion of the law is not severable, then the entire KIT is unconstitutional.

COUNT IV

Refunds

33. Plaintiffs incorporate the above allegations in this cause of action.

34. The Plaintiffs and members of the class or classes they represent have been, are, and shall be (as the case maybe) required to pay, without predeprivation remedies, KIT on out-of-state interest, upon pain of suffering criminal fines and penalties for non-payment of said tax, KRS 141.990.

35. From 1993 (perhaps earlier) to 1996, KRS 134.590 (or its predecessor) required that a [sic] application for refund be made "in each case" thereby effectively precluding class actions for tax refunds under KRS 134.590 (or its predecessor). The "in each ease" requirement was removed from KRS 134.590 in 1996 effective for taxable years beginning after December 31, 1995. (Effective for "taxable years beginning after December 31, 1995." Compiler's Notes, Section 11 of Acts 1996, ch. 344.) KRS 134.590 applies to the refund of taxes held unconstitutional. No protest is required. When a statute is held unconstitutional, however, the agency "shall refund the money" paid under color of the unconstitutional statute, with no provision for limiting said repayment to the "part thereof . . . wrongfully collected." Class members who paid the illegal taxes at any time during the class period are entitled to the greater of (a) a refund of all KIT paid if the KIT statute is held unconstitutional or (b) if the KIT statute is held severable, the part thereof of the KIT wrongfully collected.

36. If the Defendants cannot provide Plaintiffs the relief sought under KRS KRS [sic] 134.590, if that statute is held to allow recovery only for the illegal tax increment, then all KIT paid by taxpayers at any time during the class period must be disgorged.

37. As a result of the many thousands of unlawfully taxed transactions, Plaintiffs and each class member are entitled to tax refunds as set forth herein.

WHEREFORE, Plaintiffs demand judgment against Defendants:

A. Certifying this action as a class action and designating plaintiffs as class representatives and plaintiffs' counsel as class counsel;

B. Declaring that the additions required by KRS 141.010(10)(c) and (12)(c) violate the United States Constitution and the Constitution of the Commonwealth of Kentucky and are therefore null and void insofar as they relate to the transactions of the Plaintiffs and the class or classes as described herein;

C. Restraining and permanently enjoining and prohibiting Defendants from collecting or attempting to collect the KIT on interest income derived from obligations of sister states and/or their political subdivisions;

D. Declaring that Plaintiffs and the members of the class they represent are entitled to refunds of any KIT they have paid as a result of being obligated under color of law to pay KIT on interest income derived from obligations of sister states and/or their political subdivisions; and,

E. Any and all other relief to which they may be entitled.

Dated: Louisville, Kentucky

April 11, 2003

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COMMONWEALTH OF KENTUCKY
JEFFERSON CIRCUIT COURT
DIVISION 3
CIVIL ACTION NO. 03-CI-03282

GEORGE W. DAVIS AND
CATHERINE V. DAVIS **PLAINTIFFS**

VS. **ANSWER**
(Filed May 5, 2003)

REVENUE CABINET,
COMMONWEALTH OF
KENTUCKY, et al **DEFENDANTS**

* * *

First Defense

1. As to ¶ 1 of the Complaint, the Defendants admit that this paragraph characterizes the general nature of the claims that appear to be asserted, and the relief that appears to be demanded by the Plaintiffs, in the Complaint. The Defendants admit the last sentence of this paragraph. The Defendants deny that the Plaintiffs are entitled to the relief requested or referred to in this paragraph and in this Complaint generally and they deny that the Plaintiffs' claim(s) is (are) valid or well-founded.

2. As to ¶ 2 of the Complaint, the Defendants admit that KRS 42.012, but not KRS [illegible] as the Plaintiffs allege, states that "[t]he secretary of the Finance and Administration Cabinet shall be the chief financial officer of the state." The Defendants deny that the Secretary of the Finance and Administration Cabinet is a proper party through which the State may be sued to recover wrongfully collected income tax. The Defendants would deny, based upon sovereign immunity, Ky. Const. §§ 230 and

231, and relevant statutory provisions and case law, that any Kentucky income taxes previously paid by the Plaintiffs or by any one else may be recovered through an action such as that brought by this Complaint. The Defendants would admit that the Finance and Administration Cabinet is charged with the duty to issue a warrant to the State Treasurer for payment of authorized claims upon the State Treasury.

3. As to ¶ 3 of the Complaint, the Defendants would admit that there is case law to support the proposition that this Court would have subject matter jurisdiction over this action to the extent it attacks the constitutionality of the statutory provisions in question on their face. *See e.g., Commonwealth v. DLX, Inc.*, Ky., 42 S.W.3d 624 (2001). Subject matter jurisdiction is a defect or defense that cannot be waived, however, and whether a decision such as *DLX* would apply in the legal context to which this action relates must necessarily depend upon further review of existing and future case law. Accordingly, the Defendants are without Knowledge or information sufficient to form a belief as to the truth of the Plaintiffs' assertion of subject matter jurisdiction on this basis. The Defendants would admit that under KRS 23A.010 this Court is "a court of general jurisdiction [that] has original jurisdiction of all justiciable causes not exclusively vested in some other court." The Defendants are without knowledge or information sufficient to form a belief as to the truth of the Plaintiffs' assertion that jurisdiction of the subject matter of this action is not vested elsewhere – e.g., the procedure set forth in 103 KAR 1:010; KRS 131.110; 131.340; 131.370. The Defendants deny the implication of the allegation in this paragraph that "[t]he amount in controversy exceeds the minimum jurisdictional *amount*

prerequisite of this court" – namely, that this action properly seeks damages against the Defendants. This action, to the extent it seeks damages or tax refunds, cannot be brought against the Defendants because there has been no consent or waiver of sovereign immunity by the General Assembly to or for this kind of action against the Commonwealth. *See also* Ky. Const. §§ 230, 231. The Defendants would admit that the Plaintiffs seek a declaration of rights in the Complaint but are without knowledge or information sufficient to form a belief as to the truth of the Plaintiffs' assertion that they seek a declaration of rights concerning a justiciable controversy. The Defendants deny that this Court would have subject matter jurisdiction over this action under KRS 452.505 because it is connected with the payment of revenues into the state treasury. For the reasons previously stated, if this Court has subject matter jurisdiction, it would be limited to declaratory and injunctive relief with respect to the facial validity of the statutory provisions challenged in the Complaint. The Defendants deny that "[a] prima facie violation of the Commerce Clause of the United States Constitution, Art. I, Section 8, Clause 3, is alleged, and therefore Plaintiffs have no adequate administrative remedy."

4. As to ¶ 4 of the Complaint, the Defendants admit that this Court has *personal* jurisdiction over them because of the Plaintiffs' compliance with CR 4.04(6) and not because they are administrative agencies of this Commonwealth subject to suit. Whether the Defendants are truly subject to suit and to this action in particular will depend upon the applicability of a variety of principles or provisions of law. The Defendants are without knowledge

or information sufficient to form a belief as to the truth of the allegations in the last sentence of this paragraph.

5. The Defendants are without knowledge or information sufficient to form a belief as to the truth of ¶ 5 of the Complaint.

6. The Defendants would admit that the Revenue Cabinet administers and enforces most, but not all, of the tax laws of the Commonwealth, including the income tax. *See, e.g.,* KRS 131.030(1); *see also Bob Hook Chevrolet Isuzu, Inc. v. Transportation Cabinet,* Ky., 983 S.W.2d 488 (1998). The Defendants admit the second sentence of ¶ 6 of the Complaint. The Defendants deny the last sentence of ¶ 6 of the Complaint. *See, e.g.,* KRS 131.020(2); 131.030(3); *Reeves v. Gerard,* Ky., 255 S.W.2d 21 (1953).

7. The Defendants deny ¶¶ 7, 11 and 12 of the Complaint.

8. The Defendants admit ¶¶ 8, 9 and 10 of the Complaint with the qualification that the income tax statutes speak for themselves and would prevail over the Plaintiffs' characterization or description of them in these paragraphs. Furthermore, there may be other provisions of law or other facets of the statutory provisions referred to in these paragraphs that may be or become relevant to this case as it progresses and the admissions made in this paragraph of this Answer should not be construed as ruling out the Defendants' utilization of those other provisions of law at a later date where appropriate. As to ¶ 9 of the Complaint, the Defendants would deny that KRS 141.020 and 141.030 are the appropriate citations to support the second sentence of this paragraph. Instead, it would appear that KRS 141.010(10) and (11) would be the more appropriate citations.

9. As to ¶ 13 of the Complaint, the Defendants admit that they are applying and will apply the Kentucky income tax statutes as written to all persons covered by or subject to the terms of those statutes. They deny that the Plaintiffs may represent any class or members of any class.

10. The Defendants are without knowledge or information sufficient to form a belief as to the truth of ¶ 14 of the Complaint.

11. The Defendants deny ¶ 15 of the Complaint. The Defendants would further note that 134.590 does not merely "purport" to require an application or claim for refund within two years of payment of the taxes whose refund is sought as a condition precedent to a refund of unconstitutional taxes but does in fact require such an application for refund as a condition precedent to a refund of unconstitutional taxes, both by virtue of its plain language and controlling judicial precedent.

12. As to ¶ 16 of the Complaint, the Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegation that the Plaintiffs have filed refund claims. The Defendants have not been able to locate any such refund claims as of yet. The Defendants deny that any such refund claims could be properly or lawfully filed by the Plaintiffs on behalf of anyone else. The Defendants further deny that the Plaintiffs or anyone else have paid any Kentucky income tax that is unconstitutional. The Defendants also deny the validity, propriety, or legality of the "class period" concept utilized by the Plaintiffs in this paragraph.

13. As to ¶¶ 17-26, the Defendants deny that this action may properly or lawfully be maintained as a class action and assert that class certification is neither

necessary or appropriate in this case. The Defendants admit that ¶¶ 17 and 18 accurately characterizes and describes what the Plaintiffs are attempting to do by these paragraphs and the class they seek to represent; however, the Defendants deny that the class certification or class action determination sought by the Plaintiffs is lawful, proper, or warranted and they deny the validity, propriety, or legality of the "class period" concept utilized in these paragraphs. As to ¶ 19 of the Complaint, the Defendants deny the implication made therein that the four year time limitation prescribed by KRS 134.580 would govern refunds based upon the constitutional claims asserted by the Plaintiffs in the Complaint and would further assert that KRS 134.590 sets forth the time limitation that would apply in the event the Plaintiffs' claims were determined to be meritorious. The Defendants deny the last sentence of ¶ 20 of the Complaint. As to ¶ 20 of the Complaint, the Defendants would admit that the first two sentences generally or roughly describe the operation of KRS 134.580 and 134.590, except that they would deny any assertion or suggestion that any amount refunded under either of these statutes, and especially KRS 134.590, would be the entire amount of tax paid by a taxpayer for the tax year in question. Furthermore, the language of KRS 134.580 and 134.590 and any relevant judicial precedent construing them would control any question as to these statutues' meaning and effect. The Defendants are without knowledge or information sufficient to form a belief as to the truth of ¶ 21, the first sentence of ¶ 22, and ¶¶ 23-26. The Defendants deny the second sentence of ¶ 22.

14. As to ¶¶ 27, 29, 31 and 33 of the Complaint, the Defendants hereby incorporate their responses to the allegations these paragraphs incorporate.

15. The Defendants deny ¶¶ 28, 30, and 32 of the Complaint.

16. As to ¶ 34 of the Complaint, the Defendants admit that there are criminal penalties that relate to the income tax, but they would deny the implication of this paragraph that mere nonpayment of the tax triggers these criminal penalties. The Defendants deny that the Plaintiffs properly represent a class. They are without knowledge or information sufficient to form a belief as to the truth of the allegation that the Plaintiffs. are paying income tax "on out-of-state interest." As for the Plaintiffs' assertion in this paragraph that this payment was made "without predeprivation remedies," the Defendants would acknowledge that *Revenue Cabinet v. Gossum,* Ky., 889 S.W.2d 329 (1994) may tend to indicate that this is indeed the case. However, this is in the final analysis a question of law and there may be subsequent or other legal developments that may call for a different conclusion or that may provide support for a good faith argument for reversal or modification of *Gossum.* Accordingly, the Defendants are without knowledge or information sufficient to form a belief as to the truth of this "without predeprivation remedies" allegation.

17. As to ¶ 35 of the Complaint, the Defendants deny that class actions for tax refunds are permitted under KRS 134.590 in either its present form or its previous versions and deny the correctness of the Plaintiffs' Interpretation of the effect of the 1996 amendment to KRS 134.590. The Defendants admit that KRS 134.590 applies to the refund

of taxes held unconstitutional in accordance with its terms and as construed by the Kentucky courts. The Defendants deny that "[n]o protest is required." While no protest is required at the time of payment of the taxes, as in the case of KRS 138.500, a protest is required if the Cabinet denies a refund claim. *See* 103 KAR 1:010 § 2. The Defendants deny the last two sentences of ¶ 35 of the Complaint.

18. The Defendants deny ¶¶ 36 and 37 of the Complaint. They further assert that tax refunds may not be obtained from the Commonwealth by or through an action such as this. Such an action is an unauthorized suit against the Commonwealth and barred by sovereign immunity and Ky. Const. §§ 230 and 231.

19. The Defendants deny that the Plaintiffs are entitled to any of the relief requested in the Plaintiffs' demand for judgment.

20. Any allegation in the Complaint not specifically admitted above is hereby denied.

Second Defense

The Complaint fails to state a claim upon which relief can be granted.

Third Defense

The Plaintiffs lack standing.

Fourth Defense

This Court lacks jurisdiction over the subject matter.

Fifth Defense

This action is an unauthorized suit against the Commonwealth barred by sovereign immunity and Ky. Const. §§ 230 and 231.

Sixth Defense

Any ruling that the statutory provisions assailed by the Plaintiffs as unconstitutional are indeed unconstitutional should be made prospectively based upon the principles recognized in such cases as *Chevron Oil Co. v. Huson,* 404 U.S. 97 (1971) and *Yount v. Calvert,* Ky. App., 826 S.W.2d 833 (1991).

Eighth Defense

The Plaintiffs have failed to exhaust their administrative remedies. Exclusive original jurisdiction of tax controversies is vested in the Kentucky Board of Tax Appeals.

Therefore, based upon the foregoing, the Defendants request the following:

1. Dismissal of the Complaint with prejudice or a judgment in the Defendants' favor on the claims asserted in the Complaint that denies the Plaintiffs any relief or recovery against or from the Defendants.
2. An award to the Defendants of their costs and other expenses;
3. Denial of the Plaintiffs' request that this action be maintained as a class action;

4. Any and all other relief to which the Defendants may appear entitled.

Respectfully submitted

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CERTIFICATE OF SERVICE

I hereby certify that a true copy of the foregoing Answer was served upon M. Scott Barrett and Dennis T. Trainor, Barrett & Associates, 30 North LaSalle Street, Suite 3900, Chicago, Illinois 60602; Donn H. Wray, Stewart & Irwin, 251 East Ohio, Suite 1100, Indianapolis, Indiana 46204-2118; Hart L. Robinovitch, Zimmerman Reed P.L.L.P., 14646 N. Kierland Blvd., Suite 145, Scottsdale, Arizona 85254 and Irvin D. Foley, David W. Gray, and Anthony D. Raluy, Foley, Bryant & Holloway, Kentucky Home Life Building, 239 South Fifth Street, Suite 1700, Louisville, Kentucky 40202 by first-class mail on this the 5th day of May, 2003.

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FILED
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OFFICE OF THE CLERK
SUPREME COURT, U.S.

(12)

No. 06-666

IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,

Respondents.

On Writ of Certiorari
to the Court of Appeals of Kentucky

BRIEF FOR PETITIONERS

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July 19, 2007

QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

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BRIEF FOR PETITIONERS

OPINIONS BELOW

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JURISDICTION

The jurisdiction of the Court is invoked pursuant to 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause, U.S. Const. Art. I, § 8, cl. 3, provides that "[t]he Congress shall have Power . . . To regulate commerce . . . among the several States . . . ."

The relevant statutory provisions — Ky. Rev. Stat. Ann. § 141.020 and Ky. Rev. Stat. Ann. § 141.010 — are reproduced at Pet. App. A20—A23.

STATEMENT

Kentucky taxes interest income received by Kentucky taxpayers on bonds issued by sister States and their political subdivisions, but does not tax interest income received by Kentucky taxpayers on bonds issued by Kentucky or its political subdivisions.

The tax picture across the Nation is the same: 38 of the 43 States that tax net income or investment income, exempt interest income received on their own State bonds, but tax interest income received on sister State bonds.[1] Another 3 of the 43 States exempt interest income on some (but not all) of their own bonds, but tax interest income received on all sister State bonds. One State of the 43 exempts all State bond interest from its income tax; and one State exempts its own bonds but taxes sister State bond interest unless the sister State allows a reciprocal exemption. Seven States do not impose an income tax.

A. The Kentucky Income Tax Law

Kentucky taxes a resident individual "upon his entire net income," Ky. Rev. Stat. Ann. § 141.020(1), and a nonresident individual on net "income received by him from labor performed, business done, or from other activities in this state, from tangible property located in this state, and from intangible property which has acquired a business situs in this state," Ky. Rev. Stat. Ann. § 141.020(4).

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[1]For simplicity, Petitioners use the term "State" to refer to a State, its political subdivisions, and their instrumentalities; the term "Kentucky" to refer to the Commonwealth of Kentucky, its political subdivisions, and their instrumentalities; and the terms "State bonds," "municipal bonds," and "bonds" to refer to bonds issued by the States, their political subdivisions, and their instrumentalities.

Kentucky computes "net income" subject to tax by starting with "gross income" as defined for federal income tax purposes. Ky. Rev. Stat. Ann. § 141.010(9). Section 103(a) of the Internal Revenue Code, 26 U.S.C. § 103(a), provides that "gross income does not include interest on any State or local bond," defined to mean "an obligation of a State or political subdivision thereof," 26 U.S.C. § 103(c)(1), with the term "State" including "the District of Columbia and any possession of the United States," 26 U.S.C. § 103(c)(2).

To arrive at taxable net income, Kentucky allows most of the deductions allowed to individuals under the federal income tax law, *see* Ky. Rev. Stat. Ann. § 141.010(10), and adds back certain other items, including "interest income derived from obligations of sister states and political subdivisions thereof," Ky. Rev. Stat. Ann. § 141.010(10)(c).

The effect of the federal exclusion and the Kentucky add-back, is that Kentucky taxes interest income received by Kentucky taxpayers on sister State bonds, but does not tax interest income received by Kentucky taxpayers on Kentucky bonds.

The incidence of Kentucky's tax on sister State bond interest falls almost entirely if not exclusively on Kentucky residents. This is because income from intangibles such as municipal bonds is taxable by the State of the bondholder's domicile, and is considered taxable by a State other than the bondholder's domicile only if the bonds have acquired a "business situs," *i.e.*, become "localized in some independent business or investment," outside the State of domicile. *Cf. Kentucky Department of Revenue v. Bomar*, 486 S.W.2d 532, 535 (Ky. 1972) (property tax case). Kentucky would tax a non-resident on sister State bond interest only in the rare cir-

cumstance when the sister State bonds have become "localized in some independent business" conducted in Kentucky by the non-resident.

B. The Municipal Bond Market

A municipal bond is an interest-bearing debt security obligating the issuer to pay specified principal and interest. "State and local governments issue bonds to raise capital for essential public facilities, services, infrastructure, and general capital improvements." Belmonte, *Tax-Exempt Bonds, 2003-2004* p. 246 (IRS Statistics of Income Division, September 2006).[2] *Cf. South Carolina v. Baker*, 485 U.S. 505, 531 (1988) (O'Connor, J., dissenting) (municipal bonds are "an essential source of funding" for States and their political subdivisions).

State and local governmental units issued over $891 billion of bonds during the two years 2005-2006, more than double the $425 billion of municipal bonds issued just 10 years before in 1995-1996.[3] By the end of 2006, total municipal bond debt outstanding of State and local governments verged over $2.4 trillion,[4] and by the end of the first quarter of 2007 total State and local bonds outstanding exceeded

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[2]Belmonte, *Tax-Exempt Bonds, 2003-2004* p. 246 (IRS Statistics of Income Division 2006), available at http://www.irs.gov/pub/irs-soi/04govbnd.pdf. The Internal Revenue Service Statistics of Income Division maintains detailed information on dollar volume of municipal bonds issued, purpose or use of bond proceeds, state-by-state volume and use of proceeds, as well as reports prepared by the Special Studies Special Projects Section of the Statistics of Income Division, accessible at http://www.irs.gov/taxstats/charitablestats/article/0,,id=97029,00.html.

[3]*The Bond Buyer/Thompson Financial 2007 Yearbook*, "Municipal Financing: 1896-2006" p. 14.

[4]*Id.* p. 100.

$2.466 trillion, up $211 billion over the first quarter of 2006.[5]

Municipal bonds finance the backbone of America. Of the $432 billion in municipal bonds issued in 2006, over 27% financed projects and programs related to education; over 10% financed transportation facilities; another 10% financed utilities projects; 9.2% financed health care projects; 7.3% financed housing projects and programs; 3% financed electric power projects; and 1.8% financed environmental projects. Bonds issued for general purposes, which include financing the daily operations of States and local governments in anticipation of quarterly tax revenues, accounted for 26.6% of the total.[6]

The trade press frequently describes municipal bonds as either "general obligation bonds" or "revenue bonds." The term "general obligation bond" refers to a bond backed by the full faith and credit of the issuer to apply all sources of revenue, unless specifically limited, to the payment of principal and interest according to the terms of the bond indenture. The term "revenue bond" is generally used to refer to bonds backed by a particular stream of revenue, such as tolls or user fees, rather than general tax revenues. General obligation bonds accounted for 35% of municipal bonds issued in 2006, while revenue bonds accounted for 65% of bonds issued.[7]

Congress has always excluded State bond interest from gross income subject to the federal income tax, begin-

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[5]Posner, "Tender Option Bond Trusts Drive Q1 Muni Holdings," *The Bond Buyer,* June 15, 2007.

[6]*The Bond Buyer/Thompson Financial 2007 Yearbook*, "Two Decades of Bond Finance: 1987-2006," p. 7, and "Two Decades of Note Finance: 1987-2006," p.13.

[7]*Id.*

ning with the very first federal income tax statute. Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 168. The federal tax exclusion "effectively lowers the borrowing costs of tax-exempt debt issuers, since bondholders are generally willing to accept an interest rate lower than that earned on comparable taxable bonds." Belmonte, *Tax-Exempt Bonds, 2003-2004* p. 246 (IRS Statistics of Income Division 2006). The tax-free status of municipal bonds allows the bond issuer to borrow money at a lower interest rate than it could obtain from other sources of financing. Investors are willing to accept lower interest rates precisely because of the advantages an investor gains from the tax exemption. The Bond Market Association, *The Fundamentals of Municipal Bonds* 27 (5th ed. 2001).

The widespread and longstanding practice of the States in exempting their own bonds from state income tax adds to the attractiveness of State bonds as investments for taxpayers of the issuing State. The importance of the State level exemption (versus the federal exclusion) is demonstrated by the rapid growth of so-called single state funds, *i.e.*, mutual funds that invest in the municipal bonds of a single State. After Congress changed the tax treatment of mutual funds so that bond mutual fund dividends would be exempt from state and federal tax,[8] these single state funds mushroomed in popularity. As of May 31, 2007, total mutual fund holdings of municipal bonds were $378 billion in municipal bond funds (a category including both diversified and single state funds) and $388 billion in tax-free money market funds (some of which are also single state funds).[9] The sin-

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[8] *See* Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520 (codified at 26 U.S.C. § 852(b)(5)).

[9] Investment Company Institute, *Trends in Mutual Fund Investing May 2007* (2007), available at http://www.ici.org/home/trends_05_07.html.

gle largest municipal bond fund is a single state fund,[10] and industry sources estimated that at the end of 2005, 13% of all outstanding municipal bonds, or about $290 billion, were held by single state funds.[11]

C. Kentucky's Participation in the Municipal Bond Market

Kentucky and its political subdivisions had outstanding as of June 30, 2006 approximately $33.8 billion in bonds, consisting of $5.1 billion in State appropriation supported bonds; $3.3 billion in State non-appropriation supported bonds; $17.5 billion in county, city, special district, and local agency bonds; and $7.9 billion in industrial revenue bonds.[12]

The Kentucky Constitution, ratified in 1891, requires voter approval by general referendum prior to the issuance of general obligation bonds in amounts exceeding $500,000. Ky. Const. § 49. The Commonwealth has not issued any general obligation bonds since 1966; none are currently outstanding. Bonds issued by the Commonwealth (versus its political subdivisions) are currently classified by Kentucky as "appropriation supported bonds" and "non-appropriation supported bonds." The former category, while not "general

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[10] *The Bond Buyer/Thompson Financial 2007 Yearbook*, "Top 200 Municipal Mutual Funds: 2006," p. 102.

[11] Municipal Market Advisors, *Weekly Outlook*, Oct. 23, 2006.

[12] *See* Kentucky Finance and Administration Cabinet, *Supplementary Information to the Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2006* pp. 406-409 (2006), available at http://finance.ky.gov/ourcabinet/caboff/OOC/supplemental-reports.htm. Kentucky Finance and Administration Cabinet, *Local Debt Report FY 2006* Table I – Summary of Debts Outstanding by Governmental Unit (2006), available at http://www.gold.ky.gov/NR/rdonlyres/CDA11907-33DD-4B2E-A8D1-219DABFAC200/0/06302006DebtReport.pdf.

obligation bonds," includes bonds issued by various State authorities (such as the State Property and Buildings Commission, the Turnpike Authority of Kentucky, and the nine State universities), and are funded wholly or partially by biennial appropriations of the Kentucky General Assembly as well as project revenues, if any. The latter category consists of bonds issued by other State authorities (such as the Kentucky Housing Corporation and the Kentucky Higher Education Student Loan Corporation) which are secured solely by and payable solely from certain specified revenues, and which the General Assembly does not intend to support by appropriations.[13]

D. Proceedings Below

Respondents commenced this case in April 2003 as a declaratory judgment action in Jefferson Circuit Court, a Kentucky trial court of general jurisdiction. According to the Complaint, Respondents are Kentucky taxpayers who are "individual residents of Jefferson County," Kentucky, in which the Commonwealth's largest city, Louisville, is located.

The Complaint states that Respondents paid Kentucky income tax "on interest income derived from obligations" of sister States. J.A. 20. The Complaint asserts that Kentucky's income tax law violates the Commerce Clause by "discriminat[ing] on its face against the holders of obligations" of sister States " by imposing a tax and corresponding burden on such interest income that is greater than that im-

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[13] *See* Kentucky Finance and Administration Cabinet, *Supplementary Information to the Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2006* p. 405 (2006).

posed on interest income derived from" Kentucky bonds. J.A. 25.

Petitioner Department of Revenue of Kentucky is a department of the Petitioner Finance and Administration Cabinet of the Commonwealth of Kentucky which "exercise[s] all administrative functions of the [Commonwealth of Kentucky] in relation to the [Commonwealth's] revenue and tax laws." Ky. Rev. Stat. Ann. § 131.030(1).

Petitioners filed an Answer to the Complaint, J.A. 29—38, and moved for summary judgment. The Jefferson Circuit Court granted the Petitioners' motion. Pet. App. A15—A19. The Circuit Court relied upon the market participation exception and held that Kentucky's law did not violate the Commerce Clause. Pet. App. A18. The Circuit Court held that "[w]hen a state issues municipal bonds, it participates in the bond market by supplying bonds to the market and paying interest on those bonds." Pet. App. A18.

The Circuit Court also found that "States have a legitimate interest in attracting local funds for local public works projects . . . . Each state has a legitimate interest in drawing upon a major source of tax revenue while creating an incentive for investors to purchase state bonds." Pet. App. A18–A19.

The Respondents appealed. The Kentucky Court of Appeals, in an Opinion rendered in January 2006, vacated the Circuit Court's judgment and remanded the case for further proceedings. Pet. App. A1, A13. The Court of Appeals held that "Kentucky's bond taxation system is facially unconstitutional [under the Commerce Clause] as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." Pet. App. A6.

The Court of Appeals did not dispute "that Kentucky acts as a market participant when it issues bonds," but held that "the market participant theory is inapplicable as a State's 'assessment and computation of taxes' is, clearly, 'a primeval governmental activity.'" Pet. App. A10 (footnotes omitted).

Petitioners timely filed a motion for discretionary review by the Kentucky Supreme Court, which on August 17, 2006, denied review. Pet. App. A14.

SUMMARY OF ARGUMENT

I. Kentucky's exercise of its power as an independent sovereign to tax sister State bond interest neither "discriminates against interstate commerce" nor threatens any of the principal purposes of the dormant Commerce Clause.

A. Kentucky's tax on sister State bond interest does not "discriminate against interstate commerce" because for Commerce Clause purposes Kentucky is not "similarly situated" to sister State bond issuers, and Kentucky bonds are not "substantially similar" to sister State bonds.

Kentucky is not a "substantially similar entity" to any other bond issuer, public or private, because no other issuer has the political responsibility of financing public works and public projects for Kentucky citizens. Nor are Kentucky bonds "substantially similar" to bonds issued by other entities in the two most important aspects of any debt instrument: use of proceeds and source of repayment.

The use of Kentucky bond proceeds is made unique by the nature of the projects and programs financed (Kentucky projects versus projects in other States) and by the

common citizenship of the primary beneficiaries or users of those projects (Kentucky citizens versus citizens of other States). The sources of repayment, taxes and project revenues which are an inherent aspect of Kentucky's sovereignty, cannot be accessed or subjected to the payment of sister State bonds or private bonds. No other issuer can ever own or become entitled to these sources of repayment.

B. Kentucky's tax law does not "discriminate against interstate commerce" because it treats all bond issuers, other than Kentucky itself, in exactly the same fashion.

The constitutional distinction drawn in *United Haulers* between an entity "vested with the responsibility of protecting the health, safety, and welfare of its citizens," and all other entities which do not share that governmental responsibility is an equally valid constitutional marker whether the entity on the other side of the line is a "private" entity or some other "public" entity.

Each of the four factors of the *United Haulers* analysis — governmental responsibility; legitimate goals unrelated to economic protectionism for in-state private businesses; a typical and traditional government function; and political accountability to those most directly affected by the law — fully supports the constitutionality of the Kentucky law when applied to the circumstances of this case.

C. Kentucky's disparate tax treatment of sister State bond interest income does not threaten any of the four principal purposes of the dormant Commerce Clause. Two of the four National goals that animate the Court's dormant Commerce Clause jurisprudence — national regulatory uniformity and political solidarity — are not jeopardized by the disparate treatment of sister State bond interest. The third

goal of a national free market is inapplicable to the business of government. The fourth goal of preventing "economic protectionism" of in-state private business neither applies to a State's actions on its own behalf nor would be advanced by invalidating the laws of more than 40 States.

D. The constitutional principles of State sovereignty established by four lines of authority — federalism, immunity from suit, eminent domain, and the state taxing power — mandate the application of the *United Haulers* rule. These decisions, which cabin a State's sovereignty within its independent territorial and legal jurisdiction, and which simultaneously admit of no other sovereignty within that jurisdiction save the National Power, cannot be squared with an interpretation of the dormant Commerce Clause that would require a sovereign State to treat sister States for purposes of taxation any differently than all other entities.

II. The substantial reliance interests and settled economic expectations of the States and their bondholders, as well as Congress' repeated recognition of the disparate tax treatment of State bond interest, make judicial intervention both unwise and unnecessary.

Any change in the status quo would affect the settled economic expectations and contract rights of at least 42 States and millions of bondholders. Restraint is the wiser course of action, particularly appropriate where "considerations of state sovereignty" are so much in the balance.

Congress has studied the matter in excruciating detail, in the specific context of a thorough examination of state taxation of interstate commerce, and done nothing. The circumstances of this case present an inauspicious occasion for the Court to extend the constraints of the dormant Commerce

Clause to a market where the only "commerce" is conducted by the States themselves.

III. A sovereign State may use its regulatory taxing power to affect the economic terms of market participant relationships with its direct trading partners.

The bedrock principle of the Court's market participation cases is that if the State is acting as a market participant, the dormant Commerce Clause does not constrain the use of the State's regulatory power to set the terms of its market participation.

When Kentucky exempts interest income on its own bonds from its own income tax, Kentucky sets the terms and conditions upon which it will obtain essential bond financing. *Alexandria Scrap, Reeves,* and *White* all involved the use of the police power, a regulatory power every bit as primeval as the power to tax.

Kentucky's bond interest exemption affects the terms of its own economic relationship as debtor with its bondholders as creditors during the course of an ongoing commercial relationship in which the State retains a continuous proprietary interest in the subject of the contract, namely its bonds. The exemption is nothing more than an economic term of Kentucky's relationship with its direct trading partners, no more objectionable than a discount or a rebate would be if Kentucky bought goods or services. The taxation of sister State bond interest is nothing more than a revenue measure no more objectionable than the taxation of corporate bond interest.

ARGUMENT

Alexander Hamilton believed "that the individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants." Hamilton had no doubt that the States "would, under the plan of the convention, retain that authority in the most absolute and unqualified sense; and that an attempt on the part of the national government to abridge them in the exercise of it, would be a violent assumption of power, unwarranted by any article or clause of its Constitution." *The Federalist No. 32* (A. Hamilton).

Over 125 years ago, *Bonaparte v. Tax Court*, 104 U.S. (14 Otto) 592, 594 (1881), upheld the ad valorem taxation of sister State bonds by the bondholder's State of residence, and maintained that that "We know of no provision of the Constitution which prohibits such taxation." The Court held that within the jurisdiction of the taxing State, its sister State had none "of the attributes of sovereignty as to the debt it owes." *Id.* at 595. *Bonaparte* remarked that "[w]hile the Constitution . . . might have been so framed as to" exempt bonds of the issuer State from taxation in other States, "it has not been, and the States are free to extend the comity which is sought, or not, as they please." *Id.*

Hamilton offered his thoughts in defense of the scope of the National taxing power. *Bonaparte's* sweeping declaration anchored a Full Faith and Credit Clause case. But they frame this dormant Commerce Clause case as well. The stakes include not only the stability and efficiency of the $2.4 trillion municipal bond market, but the retained power of the States "to raise their own revenues for the supply of their own wants" and the constitutional status of the States as independent sovereigns in our federal system.

I. Kentucky's exercise of its power as an independent sovereign to tax sister State bond interest neither "discriminates against interstate commerce" nor threatens any of the principal purposes of the dormant Commerce Clause.

Since 1977, the Court has held that a state tax affecting interstate commerce is valid under the dormant Commerce Clause if "the tax is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); *American Trucking Ass'ns, Inc. v. Michigan Public Service Comm'n*, 545 U.S. 429, 437 (2005).[14]

Respondents have not alleged that Kentucky's tax on sister State bond interest received by individual taxpayers lacks a substantial nexus to Kentucky, is unfairly apportioned between Kentucky and other States, or is not fairly related to services provided by Kentucky. *See* Plaintiffs' Complaint, J.A. 13—28.

Nor would any such contention be well founded. Insofar as nexus with Kentucky is concerned, the tax only ap-

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[14]For the past 30 years, the Court has not attempted any further analysis of a State tax statute which satisfies the *Complete Auto Transit* test. The conclusion to be drawn from this consistent methodology is that if the tax satisfies the nexus, fair apportionment, and fair relationship to State services requirements, any burden on the taxed article is constitutionally tolerable, because "it was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business." *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938).

plies to bond interest income received by (i) individuals who are residents of Kentucky, and (ii) non-resident individuals if the bonds have acquired a business situs in Kentucky. Fair apportionment is not an issue because no other State can constitutionally tax the sister State bond interest income that is subject to Kentucky tax, and Kentucky cannot constitutionally tax a non-resident on sister State bond interest income unless the bonds have acquired a business situs in Kentucky.[15] The fair relationship between the Kentucky income tax and the services provided by Kentucky to its residents (and to non-residents whose bonds have acquired a business situs in Kentucky) is self-evident.

The only requirement of the *Complete Auto Transit* test put in issue by Respondents is whether Kentucky's tax on sister State bond interest income "discriminates against interstate commerce." The answer is no.

A. Kentucky's tax on sister State bond interest does not "discriminate against interstate commerce" because for Commerce Clause purposes Kentucky is not "similarly situated" to sister State bond issuers, and Kentucky bonds are not "substantially similar" to sister State bonds.

"[A]ny notion of discrimination [against interstate commerce] assumes a comparison of substantially similar

[15]Kentucky does tax a Kentucky resident on his "entire net income," Ky. Rev. Stat. Ann. § 141.020(1), which would include sister State bond interest income even if the bonds had acquired a business situs outside Kentucky. But Kentucky would give the resident taxpayer a credit for any tax paid to the business situs State, *see* Ky. Rev. Stat. Ann. § 141.070(1), obviating any issue of double taxation or fair apportionment among the States.

entities." *General Motors Corp. v. Tracy*, 519 U.S. 278, 824 (1997); *accord, United Haulers Ass'n, Inc. v Oneida–Herkimer Solid Waste Management Auth.*, 127 S.Ct. 1786, 1795 (2007) (same). "Disparate treatment constitutes discrimination only if the objects of the disparate treatment are, for the relevant purposes, similarly situated." *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 601 (1997) (Scalia, J. dissenting).

Kentucky is not a "substantially similar entity" to any other bond issuer, public or private, because no other issuer has the political responsibility of financing public works and public projects for Kentucky citizens. Nor are Kentucky bonds "substantially similar" to bonds issued by other entities in the two most important aspects of any debt instrument: use of proceeds and source of repayment.

The issuer of a Kentucky bond is the Commonwealth, one of its political subdivisions, or one of their instrumentalities, which together constitute "the one entity responsible for ensuring that the job gets done" for the citizens of Kentucky, versus "all other enterprises," *C&A Carbone, Inc. v. Town of Clarkston*, 511 U.S. 383, 411 (1994) (Souter, J., dissenting). Bonds issued by Kentucky finance Kentucky public works and support Kentucky public projects and programs. No other bond issuer, public or private, takes any responsibility whatsoever for Kentucky public works or Kentucky public projects and programs. Kentucky taxpayers who hold bonds issued by sister States are not provided public education, police and fire protection, or water and sewer services in Kentucky by any sister State.

The "relevant purposes" here are the financing and provision of public works and programs in Kentucky. For

these purposes, sister States are no more "similarly situated" to Kentucky than the government of Egypt.

Both the use of proceeds and the source of repayment of Kentucky bonds distinguish them from bonds of any other issuer. Proceeds of Kentucky bonds finance Kentucky public projects and programs. Proceeds of sister State bonds, and proceeds of private entity financings, in no way pay for Kentucky public works and projects. The use of Kentucky bond proceeds is made unique by the nature of the projects and programs financed (Kentucky projects versus projects in other States) and by the common citizenship of the primary beneficiaries or users of those projects (Kentucky citizens versus citizens of other States).

The sources of repayment for Kentucky bonds also constitutionally distinguish Kentucky bonds from bonds of all other issuers. Kentucky pays the interest on and the principal of Kentucky bonds, from tax revenues collected from Kentucky taxpayers and from project/program revenues collected by Kentucky bond projects. These sources of repayment, which are an inherent aspect of Kentucky's sovereignty, not only do not support any sister State bonds or go to repay any corporate bonds. These sources of repayment cannot be accessed or subjected to the payment of sister State bonds or private bonds. No other issuer can ever own or become entitled to these sources of repayment.

The Court's analysis of whether "local distribution companies" (LDC's) and independent marketers of natural gas should be treated as "substantially similar entities" for Commerce Clause purposes in *General Motors v. Tracy* provides a framework for the inquiry here.

The *General Motors* Court began by noting that while LDC's and independent marketers did not compete in serving the captive, residential market for natural gas, the two types of entities did compete in serving the non-captive industrial end user market. 519 U.S. at 303. *General Motors* established that some competition between two types of entities, does not settle the question whether the entities are "substantially similar" for Commerce Clause purposes. Instead, the Court held that the issue was whether to "accord controlling significance to the noncaptive market in which they compete, or to the noncompetitive, captive market in which the local utilities alone operate." *Id.* at 303-304.

The teaching of *General Motors* directly applicable here is that the mere fact that Kentucky bonds and sister State bonds are debt obligations purchased by investors in interstate commerce, does not make the issuers or their bonds "substantially similar" for Commerce Clause purposes.

General Motors identified three reasons supporting its decision to give greater weight to the captive market, and "hence to treat marketers and LDC's as dissimilar" for Commerce Clause purposes. Each reason, in the circumstances of this case, militates against treating Kentucky as a "substantially similar entity" compared to sister State issuers.

"First and foremost," *General Motors* "recognize[d] an obligation to proceed cautiously lest we imperil" delivery of bundled gas services to the captive residential market. *Id.* Here, there is every reason to think that invalidating the disparate treatment of State bond interest would materially disrupt if not destabilize the municipal bond market and the public finance programs of more than 40 States. The financing of essential public works and government operations might well be imperiled.

Second, *General Motors* confirmed the Court's "lack [of] expertness and the institutional resources necessary to predict the effects of judicial intervention." That reason cuts, if anything, even more sharply here due to the complexity and sheer size of the municipal bond market.

Third, *General Motors* pointed out that "should intervention by the National Government be necessary, Congress has both the resources and the power" to take appropriate action. That observation counsels special restraint here, in light of Congress' longstanding recognition of the importance of bond financing to the States, Congress' awareness and approval of the disparate tax treatment of sister State bond interest, and the lack of any signal from Congress that intervention by the National Government is desirable.

Municipal bonds are issued by the sovereign States to finance public projects and programs. Because no State provides public works and services within a sister State's jurisdiction, the concept of a "similarly situated sovereign State" is an oxymoron. The Court should accord "controlling significance" to the mutually exclusive political responsibilities of State bond issuers, to the completely distinct use of proceeds of State bonds, and to the inherently independent sources of repayment for bonds issued by different States.

B. Kentucky's tax law does not "discriminate against interstate commerce" because it treats all bond issuers, other than Kentucky itself, in exactly the same fashion.

The Court's watershed decision last Term in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Auth.*, 127 S.Ct. 1786 (2007), is controlling here.

The Kentucky law does not "discriminate against interstate commerce" because it treats all issuers other than Kentucky itself — public, private, in-state, out-of-state — exactly the same. The dormant Commerce Clause requires no more.

United Haulers involved county ordinances which required all solid waste haulers to bring garbage to a processing facility owned and operated by a single public benefit corporation. The ordinances prohibited delivery of waste for processing at any other processing facility, whether in-state or out-of-state. The Court held that "because the flow control ordinances . . . benefit a clearly public facility, while treating all private companies exactly the same . . . . such flow control ordinances do not discriminate against interstate commerce for purposes of the dormant Commerce Clause." 127 S.Ct. at 1795.

The constitutional line drawn by *United Haulers* is between an entity "vested with the responsibility of protecting the health, safety, and welfare of its citizens," 127 S.Ct. at 1795, and all other entities which do not share that governmental responsibility. This line is an equally valid constitutional marker whether the entity on the other side of the line is a "private" entity or some other "public" entity. *United Haulers* would have reached exactly the same result had the plaintiff trash haulers wanted to deliver their garbage to some "public" trash processing facility out-of-state.

In concluding that a law which benefits an in-state public entity while treating all other entities exactly the same does not "discriminate against interstate commerce," *United Haulers'* reasoning focused on four factors: governmental responsibility; legitimate goals unrelated to economic protectionism for in-state private businesses; a typical and traditional government function; and political accountability to

those most directly affected by the law. Each of these factors, applied to the circumstances of this case, fully supports the constitutionality of the Kentucky law.

United Haulers first noted that "unlike private enterprise, government is vested with the responsibility of protecting the health, safety, and welfare of its citizens." 127 S.Ct. at 1795. This factor applies with equal force in comparing all sister States against Kentucky. Only Kentucky is "vested with the responsibility of protecting the health, safety, and welfare of *its* citizens" (emphasis supplied). Insofar as the "health, safety, and welfare" of Kentucky's citizens are concerned, a sister State has exactly the same responsibility as a private enterprise: none. Thus the same "compelling reasons" identified by *United Haulers* for treating "these laws [favoring a public entity] differently from laws favoring particular private businesses over their competitors," are no less compelling when the comparison is between a sister State and Kentucky.

United Haulers' second point was that unlike laws favoring in-state versus out-of-state private business which are "often the product of 'simple economic protectionism,'" a law "favoring local government, by contrast, may be directed toward any number of legitimate goals unrelated to protectionism." *Id.* at 1795—1796. The same conclusion obtains when a law favors the State itself versus its sister States.

The most obvious legitimate goal "unrelated to protectionism" is the State's need to finance the operations of government and the costs of capital projects. For many issuers, bond financing is not just an alternative to paying for capital projects out of current tax revenues. Bond financing is the only feasible way of paying for many capital projects.

Kentucky's tax on sister State bond interest in no way insulates private Kentucky businesses against competition from out-of-state private businesses. The tax on sister State bond interest is just as reasonable a means of raising revenue as taxing Kentucky taxpayers on interest paid by private bond issuers. Conversely, taxing interest income received by Kentucky taxpayers on Kentucky bonds, might reasonably be thought by the Kentucky General Assembly to be a zero sum game: any additional revenue collected would be offset by increased bond interest expense. Both the exemption for Kentucky bond interest and the taxation of sister State bond interest are reasonable means of achieving the legitimate goal of financing the operations of government, unrelated to protectionist measures favoring local private businesses.

The third element in the *United Haulers* analysis was the challenged law's suitability as a means of accomplishing a function that, like waste disposal, "is both typically and traditionally a local government function," with which the Court was "particularly hesitant to interfere" under "the guise of the Commerce Clause" when "Congress itself has recognized local government's vital role" in such matters. 127 S.Ct. at 1796.

Borrowing money and issuing bonds to finance government projects and programs that cannot feasibly be paid from current revenues, are both typically and traditionally a State government function. The States came into the Union with substantial Revolutionary War debts. *See Alden v. Maine*, 527 U.S. 706, 716 (1999). Municipal bonds trace their history in the United States to the 1820's, when booming cities needed capital for public projects. ZIPF, HOW THE BOND MARKET WORKS 82 (1997). Total municipal bonds issued during each of the years 1896 through 1901 ranged from $128 million to $168 million; ran between $521 million

and $891 million each year from 1910 through 1918; and exceeded $2.0 billion annually in 15 of the 20 years from 1920 through 1939. *The Bond Buyer/Thompson Financial 2007 Yearbook*, "Municipal Financing: 1896-2006," p. 15.

Congressional recognition of and support for the "vital role" of municipal bond financing could not be more visible. The federal exclusion of State and local bond interest is well understood as "a kind of revenue sharing, enabling states and cities to borrow at interest rates lower than those on taxable obligations of similar quality." BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 15.1.1 (2007). Indeed, the United States Treasury Department classifies the exclusion as a federal "tax expenditure," *i.e.*, tax revenue foregone as a result of the exclusion of municipal bond interest from the federal income tax, and for fiscal year 2007 estimates the amount of this tax expenditure by the federal government at $36.8 billion. Budget of the United States Government, Fiscal Year 2007, Analytical Perspectives, Table 19-1: Estimates of Total Income Tax Expenditures.

The fourth and final factor in the *United Haulers* analysis was political accountability, that is, that "the most palpable harm imposed by the ordinances – more expensive trash removal – is likely to fall upon the very people who voted for the laws." 127 S.Ct. at 1797. The same is true of Kentucky's taxation of sister State bond interest and Kentucky's exemption for Kentucky bond interest. The burden of the tax on sister State bond interest falls almost entirely if not exclusively on Kentucky residents, the very people whose representatives voted for the law. The burden of the exemption for Kentucky bond interest is that Kentucky arguably loses the tax revenue that might have been collected by taxing its own bonds. That revenue loss must either be

offset by increased taxes or other governmental levies, or by reductions in the level of governmental services, or both, which in all events is borne by the citizens of Kentucky, the very people whose representatives voted for the law.

C. Kentucky's disparate tax treatment of sister State bond interest income does not threaten any of the four principal purposes of the dormant Commerce Clause.

The Court's dormant Commerce Clause jurisprudence recognizes four National interests or purposes as sufficient justification for invalidating State laws affecting interstate commerce: a need for uniform national regulation; minimizing political friction between the States; promoting a national free market; and avoiding "economic protectionism." None of these goals is compromised by the disparate treatment of sister State bond interest.

The first purpose is evident in cases focused on transportation rules and price control regulations which emphasize the National interest in avoiding inconsistent State regulations that could impede interstate commerce and undermine needed national uniformity. *See, e.g., Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520 (1959); *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 476 U.S. 573, 582 (1986); *Healy v. Beer Institute, Inc.*, 491 U.S. 324, 339-340 (1989).

The Due Process Clause limitations on the taxing power of individual States provide more than sufficient protection against any inconsistency in State tax laws. No State can constitutionally tax the receipt of bond interest income by individuals other than its own residents and those few, if any, non-resident individuals whose bonds have acquired a

business situs in the taxing State. *Cf. Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 209-210 (1936) (States have no constitutional power to impose ad valorem tax on intangibles that have acquired a business situs in other jurisdictions). There is therefore no substantial possibility of conflict between State tax regimes applicable to the same income, no realistic risk of cumulative taxes to be avoided by a national uniform rule, and simply no job for the dormant Commerce Clause to do here.

The second purpose is a political goal of girding the Union against the destabilizing effects of state laws with extraterritorial effects and retaliatory state legislation enacted as a counterpunch to laws favoring local businesses in other states. *E.g., Granholm v. Heald,* 544 U.S. 460, 472 (2005) ("rule" prohibiting discrimination against interstate commerce "is essential to the foundations of the Union").

When Justice Cardozo wrote that dormant Commerce Clause review safeguards the Union against the effects of "rivalries and reprisals that were meant to be averted by subjecting commerce between the states to the power of the nation," *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 522-523 (1935), most of the States had only recently enacted income tax laws. The lesson of the intervening 70 years is that virtually all the States have found it desirable if not essential to use the state bond interest exemption to facilitate their access to the capital markets, and no State has ever challenged the taxation of its bonds by a sister State.

To the extent that the Commerce Clause should be interpreted to foster national "union and not division," and should be invoked "upon the theory that the peoples of the several states must sink or swim together," *id.* at 523, neither the goal nor the theory is threatened by the disparate tax

treatment of State bond interest. Forty two of 43 States with an income tax are swimming in the same direction. The dormant Commerce Clause does not require that they swim in the same lane, or require the Court to venture into really deep water by invalidating the disparate treatment of State bond interest in hopes of promoting the solidarity of the Union.

The third purpose surfaces in cases that extol the virtues of a national free market and warn against "economic balkanization." *E.g., Hughes v. Oklahoma*, 441 U.S. 322, 325-326 (1979); *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525 (1949) (Commerce Clause fosters for "every farmer and every craftsman . . . free access to every market in the Nation," and protects "every consumer" from "exploitation" by facilitating "free competition from every producing area in the Nation").

The free market rationale is attenuated here. The sovereign States are not farmers or craftsmen attempting to provide goods and services to the citizens of their sister States. A consumer of public goods provided and financed by Kentucky can never "look to . . . free competition" from other States to provide education, roads, sewers, prisons, and bridges for Kentucky.

Nor do the States or their citizens appear to have been economically exploited by the decentralized features of the municipal bond market. One man's economic balkanization is another man's market segmentation. Single state funds, which exist because of the disparate treatment of State bond interest, may well have provided essential market access for less populous States and local government issuers who would otherwise scratch and claw for national attention. The $2.4 trillion municipal bond market must be regarded as a howling success in providing essential capital to finance public works

and public projects, without any help from Adam Smith or the dormant Commerce Clause.

The fourth purpose of the dormant Commerce Clause is avoiding "economic protectionism — that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors," *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 192 (1994). *See, e.g., Granholm v. Heald*, 544 U.S. 460, 472 (2005); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984).[16]

The evils of "economic protectionism" are not manifested when the only "in-state economic interest" is the taxing State itself. There are no "out-of-state competitors." Unlike an out-of-state private firm competing for local business, no sister State will cross the border to provide its own brand of public goods and services to the taxing State's citizens, whether the sister State's bond interest is taxable or not.

The Court itself has said as much, finding "the label 'protectionism' of little help" in analyzing the provision of public works by sovereign States to their respective citizens, *Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980). To the contrary, "such policies, while perhaps 'protectionist' in a loose sense, reflect the essential and patently unobjectionable purpose of state government — to serve the citizens of the State." *Id.*

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[16] *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977), presents a slightly different fact pattern, because there the disparate treatment was between different types of out-of-state transactions, rather than in-state versus out-of-state transactions. The law was invalidated, however, because it was designed to steer business from out-of-state residents into the taxing state, to benefit an in-state private entity.

The Court of Appeals for the Second Circuit hit the nail on the head in *Freedom Holdings, Inc. v. Spitzer*, 357 F.3d 205, 218 (2004): "[T]here is simply no precedent to support the proposition that a state's generation of revenues at the expense of in-state and out-of-state economic interests alike is, without more, invalidly protectionist for Commerce Clause purposes."

Kentucky's tax on sister State bond interest is no more "economic protectionism" than Kentucky's tax on bond interest paid by in-state and out-of-state corporate bond issuers alike. It would make no sense for Kentucky to tax its own interest payments to bondholders as a means of raising revenue: the revenue dog would merely be chasing its interest expense tail.

In short, two of the four National goals that animate the Court's dormant Commerce Clause jurisprudence — national regulatory uniformity and political solidarity — are not jeopardized by the disparate treatment of sister State bond interest. The third goal of a national free market is inapplicable to the business of government. And the fourth goal of preventing "economic protectionism" of in-state private business neither applies to a State's actions on its own behalf nor would be advanced by invalidating the laws of more than 40 States.

D. The constitutional principles of State sovereignty mandate the application of the *United Haulers* rule.

United Haulers establishes that if a State tax law applies in exactly the same fashion to all entities — in-state, out-of-state, public, or private — other than the State itself,

the law does not "discriminate against interstate commerce" for purposes of the dormant Commerce Clause.

The Court's decisions from four lines of authority that establish the fundamental principles of State sovereignty — federalism, immunity from suit, eminent domain, and the state taxing power — directly reinforce the constitutional boundary drawn by *United Haulers*. These decisions, which cabin a State's sovereignty within its independent territorial and legal jurisdiction, and which simultaneously admit of no other sovereignty within that jurisdiction save the National Power, cannot be squared with an interpretation of the dormant Commerce Clause that would require a sovereign State to treat sister States for purposes of taxation any differently than all other entities.

The Court has frequently adopted Madison's assurance that the "jurisdiction [of the National Government] extends to certain enumerated objects only, and leaves to the several States a residuary and inviolable sovereignty over all other objects." *The Federalist No. 39* (J. Madison), *quoted in, e.g., Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528, 550 (1985). This "dual sovereignty" of each of the States and the National Government is often described as "a defining feature of our Nation's constitutional blueprint." *Federal Maritime Comm'n v. South Carolina Ports Authority*, 535 U.S. 743, 751 (2002); *Gregory v. Ashcroft*, 501 U.S. 452, 457 (1991).

The States' "residual sovereignty" is both implicitly and explicitly vouchsafed by the Constitution. "Residual sovereignty" is "implicit, of course, in the Constitution's conferral upon Congress of not all governmental powers, but only discrete, enumerated ones," and that implication is "rendered express by the Tenth Amendment's assertion that '[t]he

powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.'" *Printz v. United States*, 521 U.S. 898, 919 (1997).

While these and other federalism decisions concern themselves primarily with the interaction and interrelationship of the enumerated powers of the National Government versus the retained powers of the respective States, the Court has unremittingly held that none of the States surrendered any of their sovereignty to their sister States in the plan of the Constitution. "Rather, they entered the Union 'with their sovereignty intact.'" *Federal Maritime Comm'n*, 535 U.S. at 751, *quoting Blatchford v. Native Village of Noatak*, 501 U.S. 775, 779 (1991). The constitutional result is that the States are "independent sovereigns in our federal system," *e.g., Bates v. Dow Agrosciences LLC*, 544 U.S. 431 (2005); *Medtronic, Inc. v. Lohr*, 518 U.S. 470 (1996).

An essential attribute of the "residuary and inviolable" sovereignty retained by each of the States is the mutual exclusivity of the sovereignty of the States vis-à-vis each other. Chief Justice Marshall made this point in *The Schooner Exchange v. McFadden*, 11 U.S. (7 Cranch) 116 (1812), when he analyzed the scope of national sovereignty versus other independent nations. "The jurisdiction of the nation within its own territory is necessarily exclusive and absolute. It is susceptible of no limitation not imposed by itself. Any restriction upon it, deriving validity from an external source, would imply a diminution of its sovereignty to the extent of the restriction, and an investment of that sovereignty to the same extent in that power which could impose such restriction." *Id.* at 136.

The constitutional line drawn by *United Haulers* between the relevant governmental entity and all other entities — "private" or "public" — which do not share the governmental entity's responsibility for the welfare of its citizens, respects the independent sovereignty of the States. Any dimmer line requiring a taxing State to treat sister States any differently than private entities within its own territory and jurisdiction, would necessarily derogate from the taxing State's "inviolable" and "independent" sovereignty vis-à-vis its sister States. *Cf. Texas v. White*, 74 U.S. (7 Wall.) 700, 725 (1868) ("The Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States. . . [there can be] no loss of separate and independent autonomy to the States, through their union under the Constitution.").

The basic principle is geographical: State sovereignty does not cross the state line. The Court's adjudication of other matters where the sovereignties of different States have collided cleaves to this principle.

In *Nevada v. Hall*, 440 U.S. 410 (1979), for example, Nevada contended that its sovereign immunity from unconsented suit in its own courts, traveled with a state employee into California, so that a suit in California court could not be maintained against Nevada on *respondeat superior* grounds for its employee's negligence. The Court rejected Nevada's argument that "the Constitution implicitly establishes a Union in which the States . . . must respect the sovereignty of one another," *Id.* at 424-425. The Court held "nothing in the Federal Constitution . . . obligates" one State to an "enforced respect for the sovereignty" of a sister State within the former's jurisdiction. *Id.* at 425, 426. The Court adopted, in the context of State sovereignty, the same principle established by *The Schooner Exchange*: that the essential nature of State sovereignty is that it yields only to the National Power, so

that any requirement that one State yield, within its own jurisdiction, to the sovereignty of a sister State, necessarily contradicts the former's independent sovereignty.

Georgia v. Chattanooga, 264 U.S. 472 (1924), reached a similar result in the eminent domain context. Georgia, which owned property located in Tennessee, maintained that Tennessee could not take its property by eminent domain. The Court restricted Georgia's sovereignty to the south side of the state line. The Court affirmed the general rule that "land acquired by one state in another state is held subject to the laws of the latter and to all the incidents of private ownership." Accordingly, "the sovereignty of Georgia was not extended into Tennessee. . . . [Georgia] occupies the same position [in Tennessee] as does a private corporation authorized to own and operate a railroad." 264 U.S. at 480, 481.

This same principle of the mutual exclusivity of State sovereignty in matters of state taxation runs through the Court's Due Process Clause decisions that limn the boundaries of State power to subject intangibles, such as bonds, to ad valorem tax. There the general rule is that intangible property is "localized" at the owner's domicile, and only the State of domicile can tax the value of the intangibles. *Farmers' Loan & Trust Co. v. Minnesota*, 280 U.S. 204 (1930). The exception is that when intangibles, such as bonds, have acquired a "business situs" other than in the State of the owner's domicile, the intangibles are subject to ad valorem taxation by the State of their "business situs," and may not be constitutionally taxed by the State of the owner's domicile. The basis for the rule is that the States' "'spheres of activity are enforced and protected by the Constitution, and therefore it is impossible for one State to reach out and tax property in another without violating the Constitution.'" *Wheeling Steel*

Corp. v. Fox, 298 U.S. 193, 209 (1936), *quoting United States v. Bennet*, 232 U.S. 299, 306 (1914).

Bonaparte v. Tax Court, 104 U.S. (14 Otto) 592 (1881), likewise chose the state line as the boundary for State sovereignty in the context of an ad valorem intangible property tax on State bonds. The taxpayer in *Bonaparte* argued that the Full Faith and Credit Clause required Maryland to respect the laws of the issuing States with respect to the taxability of their own bonds. The Court rejected the contention with a statement that covered a larger constitutional landscape: "We know of no provision of the Constitution which prohibits such taxation." *Id.* The rationale of the Court's decision, however, was based on the same fundamental understanding of State sovereignty urged here: "No State can legislate except with reference to its own jurisdiction. One State cannot exempt property from taxation in another. Each State is independent of all the others in this particular." 104 U.S. at 594.

In words that apply just as directly to this case as they did to State bond debt over a century ago, *Bonaparte* noted that "if a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced interest." But the Court resolved the case on the same principle underlying the decision in *United Haulers*, namely that because the issuing State cannot exercise "any of the attributes of sovereignty as to the debt it owes" on its bonds "outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals." 104 U.S. at 595.

The holding of *United Haulers* and its application in this case are thus entirely consonant with, indeed mandated by, the fundamental constitutional principle that the States

are independent sovereigns vis-à-vis each other, and the concomitant constitutional rule that State sovereignty does not cross state lines.

II. The substantial reliance interests and settled economic expectations of the States and their bondholders, as well as Congress' repeated recognition of the disparate tax treatment of State bond interest, make judicial intervention both unwise and unnecessary.

Substantial reliance interests and settled economic expectations loom largely in this case. A $2.4 trillion municipal bond market essential to the States' ability to finance not only capital projects but their daily operations, has functioned smoothly for decades on the business assumption that disparate treatment of State bond interest is constitutionally permissible.

That business assumption has been priced into every outstanding State bond issue, one way or the other. At least four fifths of the States operate under budgets that reflect not only revenues collected from taxes on sister State bonds, but bond interest expense that is materially affected by the exemption for interest income on their own bonds.

Over 35% of all municipal bonds outstanding in 2006 were held by individuals and households, and another 33% were held by mutual funds, money market funds, and closed end funds, in all probability on behalf of individual investors.[17] The State tax treatment of municipal bonds has been taken as a given by all these bondholders.

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[17] *See The Bond Buyer/Thomson Financial 2007 Yearbook* p.100 (2007).

It is therefore no overstatement to say that any change in the status quo would affect the settled economic expectations and contract rights of at least 42 States and millions of bondholders.

Would the municipal bond market be destabilized? Would the market be transmogrified into a brave new world in which States with weaker balance sheets would become governmental junk bond issuers and smaller, local issuers might find no demand whatsoever for their bonds? Would the States struggle for years with the fiscal consequences of a radical change in the ground rules of municipal finance? We don't know. But we do know that it's bad business to push a 2.4 trillion pound gorilla out of his cage without any idea of where he's headed or what he's going to do when he gets there.

In similar Commerce Clause cases, the Court has determined that restraint is the wiser course of action. *General Motors v. Tracy*, 519 U.S. 278, 304 (1997) ("we lack the expertness and the institutional expertise to predict the effects of judicial intervention"). Restraint is particularly appropriate where "considerations of state sovereignty" are so much in the balance, and especially here where the only sellers of the product are the States themselves, so that "the competing considerations in cases involving state proprietary action will be subtle, complex, politically charged, and difficult to assess under traditional Commerce Clause analysis," *Reeves, Inc. v. Stake*, 447 U.S. 429, 439 (1980).

Justice Holmes' assessment of an analogous fact pattern in *Padell v. New York*, 211 U.S. 446, 448 (1908), is apropos. "[T]he mode of taxation is of long standing, and, upon questions of constitutional law, the long-settled habits of the community play a part as well as grammar and logic. .

. . [T]he fact that the system has been in force for a very long time is of itself a strong reason against the belief that it has been overthrown by the 14th Amendment, and for leaving any improvement that may be desired to the legislature."

It would be a gross understatement to merely say that Congress has been well aware of the disparate treatment of sister State bond interest for decades. Congress has studied the matter in excruciating detail, in the specific context of a thorough examination of state taxation of interstate commerce, and done nothing. Lack of action speaks louder than words.

In 1959, Congress enacted legislation that generally prohibited State taxation of income derived from the sale of tangible personal property in interstate commerce unless the out-of-state vendor's activities amounted to something more than "solicitation," Act of September 14, 1959, Pub. L. 86-272, 73 Stat. 555, *codified at* 15 U.S.C. § 381. Section 201 of that Act directed the House Committee on the Judiciary and the Senate Finance Committee to "make full and complete studies of all matters pertaining to the taxation by the States of income derived within the States from the conduct of business activities . . . which are a part of interstate commerce, for the purpose of recommending to the Congress proposed legislation providing uniform standards to be observed by the States in imposing income taxes on income so derived."

The resulting Report of the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, presented to Congress in 1964, began by noting that "for 175 years, the courts have had to shoulder the entire responsibility for balancing the conflicts between the tax policies of the States and the national policy of assuring

the free flow of commerce." Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives, *State Taxation of Interstate Commerce*, H.R. Rep. No. 88-1480, vol. 1, at iii (1964).

The Special Subcommittee Report, as part of its review of state taxation of "interest on governmental obligations," called to Congress' attention in 1964 that "twenty one States exempt interest on obligations issued by the taxing State or its subdivisions; fourteen consider such interest taxable," and three "exempt interest of this kind to varying degrees." *Id.* at 258 and nn. 10-11 (listing States). The Special Subcommittee then reported that "twenty nine States tax all interest on obligations issued by other States or the political subdivisions of other States," that "[e]ight States exempt such interest," and that in one State "the status" of interest on sister State obligations "is uncertain." *Id.* at 259 and nn. 12-13 (listing States).

In an Appendix to its Report, the Special Subcommittee provided Congress with a detailed description, complete with citation to the applicable State statute or regulation, of each State's treatment of interest on municipal bonds. For example, "Alabama exempts interest . . . on obligations of Alabama and its subdivisions. Ala. Code tit. 51 §§ 384(2)(d), (f). Interest on obligations of other States and their subdivisions is taxable. Reg. § 384.2(f)." H.R. Rep. No. 88-1480, vol. 2, at A371. Or, again for example, "Interest on obligations of California and its subdivisions and of other States and their subdivisions is taxable. Code § 24271." *Id.* at A377.

Congress' alphabetical, state-by-state, statute-by-statute examination of the widespread and longstanding prac-

tice of the States in exempting interest on their own bonds, but taxing interest on sister State bonds, could not have been more thorough. Yet when the Special Subcommittee formulated its recommendations in 1965 for legislative action by Congress, *see* Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives, *State Taxation of Interstate Commerce*, H.R. Rep. No. 89-952, vol. 4 (1965), the disparate treatment of sister State bond interest was not mentioned. After years of detailed study, and with its eye focused on "conflicts between the tax policies of the States and the national policy of assuring the free flow of commerce," Congress apparently did not even consider exercising its affirmative Commerce Clause power to take the action that Respondents ask this Court to require under the dormant Commerce Clause.

This is not a situation where judicial action under the dormant Commerce Clause is called for because the matter is too localized and fragmented to get on the Congressional radar screen. Quite the contrary. This matter is so vital to the public finance market, and is a concern of such obvious national dimension, that the Court may safely indulge the inference that Congress' failure to take any action since 1965 to disturb the settled expectations of the States and their bondholders warrants leaving well enough alone. "Given these factors, *Alexandria Scrap* wisely recognizes that, as a rule, the adjustment of interests in this context is a task better suited for Congress than this Court." *Reeves, Inc. v. Stake*, 447 U.S. 429, 439 (1980).

The circumstances of this case present a particularly inauspicious occasion for the Court to extend the constraints of the dormant Commerce Clause to a market where the only

"commerce" is conducted by the States themselves.[18] A more fitting opportunity for judicial restraint would be difficult to imagine. The Court should not rush in where Congress failed to tread.

III. A sovereign State may use its regulatory taxing power to affect the economic terms of market participant relationships with its direct trading partners.

The bedrock principle of the Court's market participation cases is that if the State is acting as a market participant, the dormant Commerce Clause does not constrain the use of the State's regulatory power to set the terms of its market participation.

"Our cases make clear that if a State is acting as a market participant, rather than as a market regulator, the dormant Commerce Clause places no limitation on its activities." *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82, 94 (1984). "[W]when a state or local government enters the market as a participant it is not subject to the restraints of the Commerce Clause," *White v. Massachusetts Council of Construction Employers, Inc.*, 460 U.S. 204, 208 (1983). Just as a "private market participant" operates free "from federal constraints" imposed by the dormant Commerce Clause, so do States "when acting as proprietors," *Reeves, Inc. v. Stake*, 447 U.S. 429, 439 (1980).

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[18] *Cf. In re Trade-Mark Cases*, 100 U.S. (10 Otto) 82, 96 (1879) ("[C]ommerce among the States means commerce between the individual citizens of different States.").

Kentucky, its political subdivisions, and their instrumentalities have borrowed nearly $34 billion in the municipal bond market, and annually pay billions of dollars in interest and principal payments to their creditor bondholders. A private market participant such as a corporate bond issuer no more directly participates in the corporate debt market than Kentucky participates in the municipal bond market.

Although it believed that "no one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds," the Kentucky Court of Appeals mistakenly concluded that "the market participant theory is inapplicable as a State's 'assessment and collection of taxes' is, clearly, 'a primeval government activity.'" Pet. App. A10. This view confuses a label with an analysis.

To the contrary, the Court's market participation cases neither preclude a State from using its regulatory power to set the economic terms of its continuing contractual relationships with its direct trading partners, nor disable a State from regulating or taxing third party transactions occurring in the market in which it participates.

A. A State's market participation may include the exercise of regulatory power without transgressing any dormant Commerce Clause limitations.

Because the dormant Commerce Clause is inapplicable to a State's actions as a market participant, Boston in *White* could use its regulatory powers to restrict out-of-state participation in the work crews on city projects, South Dakota in *Reeves* could use its regulatory powers to restrict the sale of state-produced cement to in-state buyers, and Maryland in *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794

(1976), could use its regulatory powers to restrict the payment of bounties to in-state scrap processors.

When Kentucky exempts interest income on its own bonds from its own income tax, Kentucky sets the terms and conditions upon which it will obtain essential bond financing. This exercise of regulatory power goes no further than what *Reeves* envisioned and approved: "'*the Government enjoys the unrestricted power* to produce its own supplies, to determine those with whom it will deal, and *to fix the terms and conditions upon which it will make needed purchases.*'" 447 U.S. at 439 n.12 (*quoting Perkins v. Lukens Steel Co.*, 310 U.S. 113, 127 (1940) (emphasis supplied).

None of *Alexandria Scrap*, *Reeves*, or *White* involved State participation in a market which the State did *not* regulate pervasively. The notion that "market participation" and "market regulation" are mutually exclusive, is a false dichotomy.

White acknowledged that the challenged Boston order, a quintessential across-the-board regulation mandating the composition of work crews on all projects funded by the City, "*regulates* employment contracts between public contractors and their employees." 460 U.S. at 211 n.7 (emphasis supplied). *White* nonetheless held that the relevant inquiry was "whether the city is participating in the marketplace when it provides city funds for building construction," *Id.* at 210. The Court concluded that whether the regulatory order would have a significant impact on firms employing "permanent work crews composed of out of State residents" was "not relevant," because "only after it is decided that the city is regulating the market rather than participating in it . . . need it be determined whether any burden on interstate

commerce is permitted by the Commerce Clause." *Id.* at 209-210.

Alexandria Scrap approved a Maryland bounty program that was part and parcel of a regulatory regime established by "a comprehensive statute," 426 U.S. at 796, pursuant to which Maryland's market participation — its deemed purchase of abandoned automobile hulks — took place within the framework of an integrated regulatory program in which all participating processors were required to be licensed; a different division of bounty payments was established for vehicles other than hulks received from licensed suppliers versus unlicensed suppliers; and a different set of procedures was established for the payment of bounties for destruction of hulks versus other vehicles. Yet Maryland's use of its primeval regulatory police power to implement its market participation, was no obstacle to the Court's conclusion that "Maryland has entered into the market itself," 426 U.S. at 806, or the Court's finding that the Maryland regulatory bounty program was "the entry by the State itself into the market as a purchaser, in effect, of a potential article of interstate commerce," 426 U.S. at 808.

Reeves referred with approval to a host of lower court decisions upholding state regulations requiring State purchases of goods and services to be made exclusively or preferentially from in-state sources versus out-of-state suppliers, 447 U.S. at 437 n.9, *citing, inter alia, American Yearbook Co. v. Askew*, 339 F.Supp. 719 (MD Fla. 1972), *sum. aff'd* 409 U.S. 904, and noted that "numerous courts have rebuffed Commerce Clause challenges directed at similar preferences that exist in a substantial majority of the states." *Id. (citation omitted)*. That the *Reeves* Court used the terms "market participant" and "market regulator" as conceptual shorthand for the conclusions reached by an analysis, rather than as substi-

tutes for analysis, is evident in note 14 of the Court's opinion: "We have no occasion here to inquire whether subsidy programs unlike that involved in *Alexandria Scrap* warrant characterization as proprietary, rather than regulatory, activity." *Id.* at 440.

It is therefore simplistic, and incorrect, to read the Court's market participation cases as holding, in any respect whatsoever, that the exercise of a regulatory power such as the power to tax, can never be part of a State's market participation. *Alexandria Scrap, Reeves, and White* all involved the use of the police power, a regulatory power every bit as primeval as the power to tax.

B. The dormant Commerce Clause does not preclude State taxation or regulation of a market in which it participates.

Maryland's market participation in *Alexandria Scrap* did not preclude Maryland from taxing the income of the hulk processors to which its regulatory bounty was paid. Nor did Boston's market participation in *White* prohibit Boston from taxing the income of the construction crews whose composition it regulated.

The Court of Appeals' error traces to three cases in which the State was not a market participant at all, but tried to equate taxation or regulation of transactions between third parties to "participation" in the market by the State. *E.g., South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82, 98 (1984); *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 271 (1988); *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564, 594 (1997).

South-Central Timber, *New Energy*, and *Camps Newfound* imposed necessary conceptual limits on the market participation exception. If a State could use its market power to impose downstream restrictions on its trading partners, or could transmute the assessment and collection of taxes, standing alone, into State "participation" in the free market, the market participation exception would swallow the dormant Commerce Clause rule.

These precedents in no way foreclose the use of a State's regulatory power to affect the economic terms of its relationship with its direct trading partners. In *New Energy* and *Camps Newfound* the State had no direct trading partners. The State's only claimed "participation" in the market was the taxation of market transactions between third parties. In *South-Central Timber* the State conceded that it "participate[d] in no way" in the relevant timber processing market to which its regulation applied.

Kentucky's bond interest exemption affects the terms of its own economic relationship as debtor with its bondholders as creditors "during the course of an ongoing commercial relationship in which the [State] retain[s] a continuing proprietary interest in the subject of the contract," 467 U.S. at 99. Kentucky does not attempt to transform naked taxation or regulation of third party transactions, into "market participation" by Kentucky. Kentucky sells its bonds to buyers and pays interest and principal to its bondholders just like any private bond issuer sells bonds and pays interest and principal to its bondholders.

There is no compelling reason that Kentucky's tax exemption for interest received on its own bonds cannot be separated, for Commerce Clause analysis, from its taxation of sister State bond interest. The exemption is nothing more

than an economic term of Kentucky's relationship with its direct trading partners, no more objectionable than a discount or a rebate would be if Kentucky bought goods or services. The taxation of sister State bond interest is nothing more than a revenue measure no more objectionable than the taxation of corporate bond interest.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

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IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF
THE COMMONWEALTH OF KENTUCKY, et al.,

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,

Respondents.

ON WRIT OF CERTIORARI TO THE
KENTUCKY COURT OF APPEALS

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QUESTION PRESENTED

Whether Kentucky's income tax scheme violates the Commerce Clause of the United States Constitution in its negative, or dormant, aspect by exempting from taxation interest income on bonds issued by Kentucky and its local governmental subdivisions while taxing interest income on bonds issued by other States and local governmental subdivisions.

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PRELIMINARY STATEMENT

This is a tax case in which Kentucky is using its tax power to discriminate against the interstate trade of out-of-state municipal bonds. Specifically, Kentucky taxes the income its citizens earn from out-of-state municipal bonds while exempting from taxation the income its citizens earn from in-state municipal bonds. The intended effect is to encourage Kentucky citizens to purchase in-state municipal bonds by discouraging their purchase of out-of-state municipal bonds. As a result, out-of-state issuers and sellers encounter a barrier to the sale of out-of-state municipal bonds in Kentucky. In the decision below, the Kentucky Court of Appeals held that this facially discriminatory tax scheme violates the dormant Commerce Clause. This conclusion is correct and the Court should affirm.

"A State's power to lay and collect taxes, comprehensive and necessary as that power is, cannot be exerted in a way which involves a discrimination against interstate commerce." *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564, 574-75 (1997) (citation and alteration omitted). Thus, a State may not use its tax power to erect barriers to interstate commerce that discriminate in favor of in-state economic interests by burdening out-of-state economic interests. *E.g.*, *New Energy Co. v. Limbach*, 486 U.S. 269 (1988). Yet, Kentucky's tax scheme does just that: It purposefully promotes the purchase of in-state municipal bonds in Kentucky by erecting a barrier to the purchase of the same out-of-state commodity.

Laws that discriminate against interstate commerce in this way are subject to "a virtually *per se* rule of invalidity." *Granholm v. Heald*, 544 U.S. 460, 476 (2005) (internal quotation marks and citation omitted). Invalidation is especially warranted here because Kentucky's law operates as a tariff; *i.e.*, a law that "taxes goods imported from other States, but does not tax similar products produced in state," *West Lynn*

Creamery, Inc. v. Healy, 512 U.S. 186, 193 (1994). Kentucky seeks to evade invalidation by citing its role as an issuer of bonds and what it does with the proceeds. But what is challenged here is not Kentucky's issuance of in-state municipal bonds, but its discriminatory taxation of out-of-state municipal bonds. The Court's precedents teach that, in tax cases like this one, the analysis focuses on the impact of the discriminatory tax on the municipal bond market. The issue is not the benefits Kentucky secures with its bond scheme, but rather the burdens it imposes with its tax scheme.

Kentucky makes no serious effort to argue that its tax scheme is valid if recognized as what it is—a facially discriminatory tax regime. Instead, it seeks refuge in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786 (2007). But Kentucky's argument ignores the vastly different circumstances of that case that led the Court to find a lack of discrimination. In *United Haulers*, the Court reviewed a flow control ordinance that was part of a State's plan to take over a local waste-handling market within a specific geographic area. The Court emphasized that the favored waste facility was publicly owned, that no out-of-state commodity faced a barrier blocking access to a private market, and that the harm caused by the ordinance was likely to fall on the very people who had voted for it. In contrast, Kentucky's scheme taxes municipal bonds that are not under Kentucky's exclusive control, blocks the access of other issuers and sellers to the private bond market, and the harm caused by the law falls largely on those who cannot vote in Kentucky.

Kentucky's other arguments as to why its tax scheme is non-discriminatory are without merit. Kentucky contends that its scheme is not discriminatory on the theory that it is not similar to other States, and its municipal bonds are not similar to other municipal bonds. It claims this special status

because only Kentucky can raise revenue for Kentucky. But every State raises revenue only for itself, and this contention demonstrates not that Kentucky is different from all other States, but that it is like all other States. So too, Kentucky's municipal bonds are exactly like those issued by other States: all are rated by the same agencies, regulated by the same federal law, compete for the same capital, and are traded by the same participants in the same national market. That Kentucky introduces bonds into the national market for a public purpose does not authorize Kentucky to use its tax power to discourage the private trade of out-of-state municipal bonds in the same market. *Everything* a State does is for a public purpose. If Kentucky can justify its tax on the ground that it serves a public purpose, any State could justify any discriminatory tax for the same reason. As the Court has explained, "the purpose of, or justification for, a law has no bearing on whether it is facially discriminatory." *Oregon Waste Sys., Inc. v. Department of Envtl. Qual.*, 511 U.S. 93, 100 (1994).

Kentucky's attempt to invoke the Court's market participation doctrine also fails. As the Court has concluded, "[a] tax exemption is not the sort of direct state involvement in the market that falls within the market participation doctrine." *Camps*, 520 U.S. at 593. Private actors do not have the power to tax, and the doctrine's rationale—to allow the State the rights of private parties—does not apply.

Kentucky's tax scheme frustrates the purposes of the Commerce Clause by promoting economic balkanization, hoarding a local resource, and exporting the costs of its tax by burdening out-of-state issuers and sellers who cannot vote in Kentucky. The scheme also harms Kentucky's interests because the purported benefit to Kentucky (*i.e.*, a reduction in its borrowing costs for municipal bonds owing to the tax-free status for its residents) is more than wiped out by its loss of tax revenues. Kentucky enacted its discriminatory tax law

because other States enacted similar laws and Kentucky is compelled to follow suit to protect its interests. The cure for this "race to the bottom" is to enforce the Court's dormant Commerce Clause precedents and affirm the decision below.

STATEMENT

A. The Respondents

Respondents George W. Davis and Catherine V. Davis are Kentucky citizens who hold (through mutual funds) a modest but diversified portfolio of municipal bonds issued by a number of States. Because of this diversification, their fortunes do not depend on the financial success or failure of a single municipal bond issue or issuer. Kentucky's tax regime penalizes the Davises for their participation in interstate commerce by taxing the income they (and other Kentucky citizens) earn on out-of-state bonds, while not taxing the income that they (and other Kentucky citizens) earn on municipal bonds issued by Kentucky and its subdivisions.

B. Municipal Bonds

Municipal bonds are debt instruments representing a contractual promise by the governmental issuer to repay the investor the principal amount of the bond with interest. They generally are of the following types: (1) "general obligation bonds," backed by the full faith, credit, and tax power of the issuing State; (2) "moral obligation bonds," not backed by the full, faith, credit, and taxing power of the State; and (3) "revenue bonds," issued to fund publicly owned infrastructure projects such as roads and schools, and backed by a pledge of the revenue generated from a specific project. J. W. Temel, THE FUNDAMENTALS OF MUNICIPAL BONDS 55-56, 58 (5th ed. 2001). "Industrial revenue bonds" (including those designated for federal tax purposes as "private activity bonds," *see* 26 U.S.C. § 141) are municipal bonds used to develop commercial or industrial property for the benefit of

private corporations and are backed by revenue from that private project or secured by property used in private business. K. Thomas Liaw & Ronald L. Moy, THE IRWIN GUIDE TO STOCKS, BONDS, FUTURES, AND OPTIONS: A COMPREHENSIVE GUIDE TO WALL STREET'S MARKETS 194 (2001).

Kentucky classifies its bonds as either "appropriation supported debt," or "non-appropriation or moral obligation debt." General obligation bonds would fall in the first category, but Kentucky has none outstanding. Instead, Kentucky issues only project revenue bonds (some of which are supported by biennial legislative appropriations), and industrial revenue bonds (which generally are not). Pet. Br. 7-8. As of June 30, 2006, $7.9 billion of the approximately $33.8 billion in Kentucky bonds are industrial revenue bonds. *Id.* at 7. Thus, roughly 23% of Kentucky's outstanding municipal bonds finance private businesses in Kentucky.

Municipal bonds are rated by independent agencies and traded in interstate commerce as financial commodities with generally standard terms. When a State (or subdivision) issues a municipal bond, it usually does not deal directly with the investing public but with intermediary underwriters. Frank J. Fabozzi, BOND MARKETS, ANALYSIS, AND STRATEGIES 189 (5th ed. 2004). Municipal bond issuers either negotiate price terms directly with underwriters or award a bond issue through a competitive process in which underwriting syndicates (temporary partnerships of bond dealers acting together) submit bids. The syndicate with the highest bid is awarded the issue. *Id.*; *see* Robert Zipf, HOW THE BOND MARKET WORKS 99 (2d ed. 1997). Once purchased, the bonds are sold to dealers or to individuals, insurance companies, commercial banks, bond mutual funds, or investment trusts. *Id.* at 106, 110. After their initial issuance and sale, the bonds are traded in the national municipal bond market. The private Bond Market Association disseminates prices for

actively traded municipal bonds and Standard & Poor's publishes a daily list of municipal bonds offered for sale in the market by over 700 broker-dealers (between 7,000 and 8,000 bonds with a par value of $1.4 billion). Temel at 105.[1]

The market ordinarily would "price" a municipal bond issue based purely on relative quality as measured in part by the rating of an independent agency. A State can distort the market-pricing function by its tax system, as Kentucky does through its tax scheme. Kentucky citizens are willing to accept less interest on Kentucky bonds because they pay no state income tax on their earnings. Because the interest on out-of-state bonds is taxed, the effective yield on these bonds is much less when the tax is taken into account. *See* Jason Van Bergen, *Weighing the Tax Benefits of Municipal Securities*, Investopedia.com, July 28, 2004, *available at* http://www.investopedia.com/articles/04/072804.asp (showing increase in equivalent taxable yield).

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[1] *See* Respondents' Supplemental Appendix ("RSA") 18a (filed herewith) (examples of Kentucky and Alabama bonds). By 1999, ninety percent of newly issued municipal bonds were issued in book-entry form. Issuers deposit a single certificate for each bond at a central clearing house, usually the Depository Trust Company Corporation ("DTC"). The investor does not receive a bond certificate; all ownership and transactional records are kept electronically. Temel at 46-47. Prospective bond purchasers are usually provided with an Official Statement (a disclosure document produced by the issuer). The document provides legal and financial information that the prospective investor may use to make an informed decision regarding investment in a new bond issue. The statement's cover page summarizes information on the bond's rating, maturity date, date of issuance, interest rate, and price. Zipf HOW THE BOND MARKET WORKS at 112; *see* RSA 21a (Cover Pages of Examples of Kentucky and Minnesota Official Statements).

C. The Challenged Tax Scheme

Kentucky's discriminatory tax scheme is described in its brief. Pet. Br. 2-3. It is undisputed that the scheme treats interest from in-state and out-of-state bonds held by Kentucky taxpayers in a facially disparate manner, by taxing interest on out-of-state municipal bonds while exempting from taxation interest on in-state municipal bonds. Kentucky is not alone in this practice; history demonstrates its gradual spread among the States as each responded to the other's discriminatory law by enacting its own.

Congress has excluded municipal bond interest from gross income subject to federal income tax beginning with the first federal income tax statute. Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 168. In 1919, New York enacted a statutory scheme that exempted from its income tax the interest earned on municipal bonds issued by New York, but denied this benefit to interest earned on bonds issued by other States. GFOA Br. 5 (1919 N.Y. Laws 1641–42). Other States soon began adopting similar measures: North Carolina in 1921, *id.* (1921 N.C. Sess. Laws 207-208); Virginia in 1926, *id.* (1926 Va. Acts 961); and Kentucky in 1936, *see Reynolds Metal Co. v. Martin*, 107 S.W.2d 251, 254 (Ky. 1937). This "race to the bottom" led to widespread retaliation, with 43 States offering some form of tax preference for interest earned on in-state municipal bonds. *See* RSA 1a; Brian Galle & Ethan Yale, *Municipal Bonds and the Dormant Commerce Clause After* United Haulers, 115 TAX NOTES 1037, 1038 (2007).

D. The Decision Below

In April 2003, the Davises filed a class action challenging Kentucky's municipal bond taxation scheme under the dormant Commerce Clause and the Fourteenth Amendment Equal Protection Clause. In July 2003, before a class had been certified, Kentucky moved for summary judgment, arguing that its scheme is constitutional. The trial court

granted the motion, relying on the market participant doctrine in ruling that the scheme does not violate the dormant Commerce Clause. "When a state issues municipal bonds," the court concluded, "it participates in the bond market by supplying bonds in the market and paying interest on those bonds." Pet. App. A18. Thus, the court held, Kentucky "may pay a higher rate of interest to resident purchasers based upon theories of distributing state created benefits and market participation." *Id.* The Davises appealed. In the decision below, the Kentucky Court of Appeals vacated the trial court's order, holding that "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." *Id.* A6. Kentucky filed a motion for discretionary review with the Kentucky Supreme Court, which was denied on August 17, 2006. *Id.* A14.

SUMMARY OF ARGUMENT

Kentucky's discriminatory tax scheme violates the dormant Commerce Clause. It taxes the income Kentucky taxpayers earn on out-of-state municipal bonds, while exempting from taxation the income they earn on in-state municipal bonds, thus discriminating on its face against out-of-state bonds by discouraging their purchase. In every substantive respect, Kentucky's law operates as a tariff by "tax[ing] goods imported from other States, but [not taxing] similar products produced in State." *West Lynn*, 512 U.S. at 193. Like any tariff, Kentucky's tax scheme is motivated by economic protectionism and promotes local economic interests over out-of-state interests. Like any tariff, Kentucky's scheme violates the purposes behind the dormant Commerce Clause. It fosters economic balkanization and retaliation, as almost every State has felt compelled to enact the same discriminatory tax law to encourage the sale of its own bonds by discouraging the purchase of other States' bonds. It hoards a

local resource by blocking access to local investment dollars. And it is undemocratic because it burdens out-of-state issuers and sellers who cannot vote in Kentucky elections. In case after case, the Court has struck down every discriminatory tax of this kind and should do so here.

Kentucky's reliance on *United Haulers* in support of its scheme is misplaced. There, the State authorized the public acquisition of the waste-handling market in a defined geographic area to remedy local environmental, health, and safety concerns. A local flow control ordinance directing local use of the public facility supported operation of the public-market facility. The ordinance was not a tax (let alone a facially discriminatory tax) and it did not exclude out-of-state waste from the facility; it simply directed local use of the local public market. In this case, Kentucky's facially discriminatory tax scheme does not support the operation of a local, publicly owned market. Rather, it operates as a tariff by burdening and exploiting the privately owned national municipal bond market, inflicting at least five distinct harms on interstate commerce. First, it harms out-of-state issuers (*i.e.*, other States and their subdivisions) by blocking their access to investment dollars in Kentucky. Second, it similarly harms out-of-state private sellers (*e.g.*, underwriters, individuals, and investment funds) who wish to sell their bonds in Kentucky. Third, it harms the national municipal bond market and its participants by distorting and impeding the free flow of capital. Fourth, it harms Kentucky investors by promoting risky, high-cost investment vehicles. Fifth, it harms the States by compelling them to enact competing discriminatory laws that decrease their net revenues. These features condemn Kentucky's law and demonstrate that it is fundamentally different from the ordinance at stake in *United Haulers*.

Kentucky's reliance on the market participant doctrine to save its tax scheme is also misplaced. As the Court's prece-

dents demonstrate, the doctrine does not apply to discriminatory tax schemes. Nor should it. The doctrine's purpose is to allow States to enjoy the same rights as private parties in their commercial dealings. But private parties have no right to manipulate the market through discriminatory taxes, and Kentucky cannot avail itself of the doctrine here.

Kentucky's arguments based on sovereign prerogatives and local autonomy fare no better. The question is not whether Kentucky is a sovereign, or whether it may issue municipal bonds for public purposes, or the like. Rather, the question is whether Kentucky may enact a discriminatory tax that discourages the trade of out-of-state municipal bonds in the national municipal bond market. Kentucky's theory is that, as a sovereign issuer operating for public purposes, it may do as it pleases. That is not and cannot be the law. If it were, there would be nothing left to the Court's discriminatory tax precedents—indeed, the dormant Commerce Clause itself—as the same argument could justify any tariff so long as the State argued it promoted a public purpose. Kentucky's theory is wrong and should be rejected.

Kentucky's arguments concerning congressional inaction, claimed reliance interests, and any financial burden that allegedly would result from an affirmance are meritless and provide no basis for reversal. The States have long known that their discriminatory tax schemes are problematic under the dormant Commerce Clause. Moreover, should the Court affirm, the market will adjust quickly without the dire consequences Kentucky predicts. More importantly, it will function as the free national market the Framers envisioned.

Kentucky's scheme also violates another constitutional restriction that supports the Court's dormant Commerce Clause precedents in the tax context. Specifically, Kentucky's discriminatory tax scheme imposes an impermissible duty on out-of-state financial commodities in violation of the

Import-Export Clause. For each of these reasons, the Court should affirm the decision below.

ARGUMENT

A. Kentucky's Tax Scheme Violates the Dormant Commerce Clause.

The Court has long recognized that the Commerce Clause in its "negative" or "dormant" aspect limits the States' power to regulate interstate commerce "even in the absence of a conflicting federal statute." *United Haulers*, 127 S. Ct. at 1792-93 (citations omitted). "Time and again" the Court has reiterated that, "in all but the narrowest circumstances," state laws violate the dormant Commerce Clause if they "mandate differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Granholm*, 544 U.S. at 472 (internal quotation marks and citation omitted). "This rule is essential to the foundations of the Union," and "reflect[s] a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation." *Id.* (internal quotation marks and citation omitted); *see Camps*, 520 U.S. at 595 ("even the smallest scale discrimination can interfere with the project of our Federal Union").

The rule aims to promote free trade and prevent the hoarding of local resources. *C&A Carbone, Inc. v. Clarkstown*, 511 U.S. 383, 392 (1994). It reflects the policy that the "States should not be compelled to negotiate with each other regarding favored or disfavored status for their own citizens" and prevents "[r]ivalries among the States" and "a proliferation of trade zones." *Granholm*, 544 U.S. at 472-73 (citation omitted). It also promotes a critical underpinning of our democracy; that of placing the costs of government regu-

lations on those who are able to vote for or against them. *United Haulers*, 127 S. Ct. at 1797 ("Our dormant Commerce Clause cases often find discrimination when a State shifts the costs of regulation to other States, because when the burden of state regulation falls on interests outside the state, it is unlikely to be alleviated by the operation of those political restraints normally exerted when interests within the state are affected.") (internal quotation marks and citation omitted).

A State's use of its tax power to attain a superior position in the national financial markets is antithetical to these principles. *Gibbons v. Ogden*, 22 U.S (9 Wheat.) 1, 231 (1824) ("If there was any one object riding over every other in the adoption of the constitution, it was to keep commercial intercourse among the States free from all invidious and partial restraints."). Indeed, a central purpose of the Commerce Clause is to curb state tax schemes that hinder interstate commerce. *E.g.*, *West Lynn*, 512 U.S. at 193 n.9 (explaining that James Madison considered the dormant aspect of the Commerce Clause more important and wrote that the Commerce Clause "grew out of the abuse of the power by the importing States in taxing the non-importing, and was intended as a negative and preventive provision against injustice among the States themselves") (citation omitted). The Court has uniformly held that discriminatory state tax schemes are essentially *per se* invalid under the dormant Commerce Clause and that rule applies here.

1. Kentucky's tax scheme facially discriminates against interstate commerce.

To determine whether a law violates the dormant Commerce Clause, "we first ask whether it discriminates on its face against interstate commerce." *United Haulers*, 127 S. Ct. at 1793. A law does so if it expressly distinguishes between in-state and out-of-state interests. *Camps*, 520 U.S. at 581 (state law affording more favorable tax treatment to

camps that served mostly in-state residents "facially discriminates against interstate commerce"). Facially discriminatory state laws are subject to the "virtually *per se* rule of invalidity," *Granholm*, 544 U.S. at 476 (internal quotation marks and citation omitted), and "the strictest scrutiny," *Hughes v. Oklahoma*, 441 U.S. 322, 337 (1979).

"All objects of interstate trade merit Commerce Clause protection," *Philadelphia v. New Jersey*, 437 U.S. 617, 622 (1978), and "[i]t is well settled that actions are within the domain of the Commerce Clause if they burden interstate commerce or impede its free flow," *Carbone*, 511 U.S. at 389 (citation omitted). The dormant Commerce Clause clearly applies to laws that discriminate against interstate investment activity, *id.* at 392 ("Discrimination against interstate commerce in favor of local business *or investment* is *per se* invalid, save in a narrow class of cases in which the municipality can demonstrate, under rigorous scrutiny, that it has no other means to advance a legitimate local interest.") (citation omitted; emphasis supplied), including tax schemes that encourage in-state investment activity—*e.g.*, the purchase and sale of securities—at the expense of out-of-state activity, *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977) (State's higher tax on securities sales made on out-of-state exchanges placed "a discriminatory burden on commerce to its sister States").

Municipal bonds, including those issued by Kentucky, are independently rated commodities traded widely in the national municipal bond market. As the court below determined, Kentucky's tax scheme "obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." Pet. App. A6. The scheme thus facially discriminates against interstate transactions in out-of-state bonds and is unconstitutional. *Carbone*, 511 U.S. at 390 ("We have interpreted the Commerce Clause to

invalidate local laws that impose commercial barriers or discriminate against an article of commerce by reason of its origin or destination out of State."). Numerous precedents compel this conclusion.

In *Boston Stock Exchange*, regional stock exchanges challenged a New York statute that taxed securities sales on out-of-state exchanges at a higher rate than it taxed sales made on a New York exchange. 429 U.S. at 319. This differential treatment prevented investors from choosing "an exchange on the basis of services, prices, and other market conditions rather than geographical proximity." *Id.* at 333. It "foreclose[d] tax-neutral decisions and create[d] both an advantage for the exchanges in New York and a discriminatory burden on commerce to its sister States." *Id.* at 331. Under the tax, "the flow of securities sales is diverted from the most economically efficient channels and directed to New York." *Id.* at 336. The Court reasoned that while "absent an undue burden on interstate commerce, the Commerce Clause does not prohibit the States from taxing the transfer of property *within* the State, the tax may not discriminate between transactions on the basis of some *interstate* element." *Id.* at 332 n.12 (emphasis supplied). The Court invalidated the tax, concluding that its "diversion of interstate commerce and *diminution of free competition in securities sales* are wholly inconsistent with the free trade purpose of the Commerce Clause," and that New York could not use its power to tax an intrastate event to require "other business operations to be performed in the home State." *Id.* at 336 (internal quotations omitted). So too here. Just as the tax in *Boston Stock Exchange* discouraged investors from choosing an exchange based on "services, prices, and other market conditions," *id.* at 333, Kentucky's tax scheme discourages Kentucky citizens from purchasing municipal bonds based on credit ratings, prices, and other market conditions, and encourages the pur-

chase of Kentucky bonds based solely on the availability of a tax exemption.[2]

In *New Energy Co. v. Limbach*, the Court unanimously struck down an Ohio statute designed to increase in-state production of ethanol by providing a tax credit to fuel dealers who sold ethanol produced in-state. Explaining that the statute was facially discriminatory because it "explicitly deprives certain products of generally available beneficial tax treatment because they are made in certain other States," 486 U.S. at 274, the Court concluded that the tax scheme "impose[d] an economic disadvantage upon out-of-state sellers" and violated the prohibition on laws "designed to give its residents an advantage in the marketplace . . . in connection with the State's regulation of interstate commerce," *id.* at 275-78. The same reasoning applies here.

In *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), the Court struck down a tax exemption for certain locally produced alcoholic beverages that encouraged the purchase of in-state beverages and discouraged the purchase of out-of-state beverages. The Court held that the exemption "violated the Commerce Clause because it had both the purpose and effect of discriminating in favor of local products." *Id.* at 273. While "a State may enact laws pursuant to its police powers that have the purpose and effect of encouraging domestic industry. . . . the Commerce Clause stands as a limitation on the means by which a State can constitutionally seek

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[2] Kentucky attempts to distinguish *Boston Stock Exchange*, stating that "the disparate treatment was between different types of out-of-state transactions, rather than in-state versus out-of-state transactions." Pet. Br. 28 n.16. But *Boston Stock Exchange* clearly involved disparate treatment between in-state and out-of-state transactions. 429 U.S. at 318 ("transactions involving an out-of-state sale [were] taxed more heavily than most transactions involving a sale within the State").

to achieve that goal." *Id.* at 271. So too here, "the Commerce Clause limits the manner in which States may legitimately compete for interstate trade." *Id.* at 272.

In *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), the Court unanimously struck down an intangible property tax that applied to corporate stock owned by North Carolina residents and that varied inversely with a corporation's presence in the State (and thus its exposure to state income taxation). The tax foreclosed tax-neutral decisions, as North Carolina taxpayers who invested in corporations with more significant North Carolina operations had a lesser tax burden than those who invested in corporations with significant out-of-state operations. The Court held the tax to be unconstitutional because it facially discriminated against interstate commerce by, *inter alia*, favoring in-state corporations over out-of-state competitors in raising capital among North Carolina residents. 516 U.S. at 333. Here, as in *Fulton*, out-of-state and in-state entities compete for sales of securities within an interstate market. In-state municipal bonds that fund economic activity within the State are no more "unique" than in-state corporate stock, and the parallel is particularly exact as to Kentucky's industrial-revenue municipal bonds that fund private business activities. As the Court held in *Fulton*, there is no justification for allowing a State to retreat into economic isolation and hoard capital from its residents in contravention of the dormant Commerce Clause. *Id.*. at 330-31, 344.

In *Camps Newfound/Owatanna, Inc. v. Town of Harrison*, the Court struck down a Maine property tax exemption for charitable institutions limited to those that principally served Maine residents. The Court found it "[un]necessary to look beyond the text of [the] statute to determine that it discriminates against interstate commerce" as the exemption disparately treated similarly situated institutions based on whether they served in-state or out-of-state campers. 520 U.S. at 575-

76. Its holding reaffirmed the core principle that "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Id.* at 581 (internal quotation omitted). Kentucky's tax scheme falls squarely within the Court's holding in *Camps*, as it penalizes Kentucky residents by increasing their tax burden for engaging in out-of-state commercial activity.

Kentucky's municipal bonds are plainly articles of interstate commerce—they are independently rated securities that are traded routinely among sellers and buyers "from all parts of the Nation." 520 U.S. at 573. They are commodities of interstate trade no less than the securities at issue in *Boston Stock Exchange* and *Fulton*, or the articles of commerce at issue in *Bacchus* and *Limbach*. Under an unbroken line of authority, Kentucky's tax scheme facially discriminates against interstate commerce and is unconstitutional.

2. Kentucky's tax scheme is unconstitutional even if the discrimination is not facial.

"The commerce clause forbids discrimination whether forthright or ingenious." *Best & Co. v. Maxwell*, 311 U.S. 454, 455 (1940). A determination that a state tax violates the Commerce Clause "may be made on the basis of either discriminatory purpose or discriminatory effect." *Bacchus*, 468 U.S. at 270 (internal citations omitted); *see Carbone*, 511 U.S. at 389-92, 394. "In each case it is our duty to determine whether the statute under attack . . . will in its practical operation work discrimination against interstate commerce." *Best*, 311 U.S at 455-56; *see West Lynn*, 512 U.S. at 201 ("Our Commerce Clause jurisprudence is not so rigid as to be controlled by the form by which a State erects barriers to commerce. Rather our cases have eschewed formalism for a sensitive, case-by-case analysis of purposes and effects."). Even if the Court were to conclude that Kentucky's tax scheme is not facially discriminatory, it is discriminatory nonetheless,

and unconstitutional under the rigorous scrutiny required by the Court's precedents.

a. Kentucky's discriminatory tax scheme is an unconstitutional burden equivalent to a tariff.

In *West Lynn*, the Court stated that "[t]he paradigmatic example of a law discriminating against interstate commerce is the protective tariff or customs duty, which taxes goods imported from other States, but does not tax similar products produced in State." 512 U.S. at 193. As the Court explained, "[a] tariff is an attractive measure because it simultaneously raises revenue and benefits local producers by burdening their out-of-state competitors," but tariffs "are so patently unconstitutional that our cases reveal not a single attempt by any State to enact one"; and thus "the cases are filled with state laws that aspire to reap some of the benefits of tariffs by other means." *Id.* Although Kentucky does not impose a tariff *per se* on out-of-state municipal bonds, its law has the same effect by taxing interest on out-of-state municipal bonds, while imposing no tax on in-state municipal bonds, thus reaping the benefits of a tariff "by other means." The scheme is unconstitutional.

As explained in *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511 (1935), laws that have the effect of "establishing an economic barrier against competition with the products of another state" essentially "set up what is equivalent to a rampart of customs duties." 294 U.S. at 527. Noting in *West Lynn* that the regulation at issue in *Baldwin* was invalid because it "had the same effect as a tariff or customs duty—neutralizing the advantage possessed by lower cost out-of-state producers," the Court held that the milk pricing order at issue in *West Lynn* was unconstitutional under *Baldwin*, *Bacchus*, and other precedents because it effectively imposed a tax that "[l]ike an ordinary tariff, . . . is thus effectively imposed only

on out-of-state products." *West Lynn*, 512 U.S. at 195. The same conclusion is warranted here.

b. Kentucky's discriminatory tax scheme is motivated by simple economic protectionism.

Facially neutral laws that are "motivated by simple economic protectionism are subject to a virtually *per se* rule of invalidity." *United Haulers*, 127 S. Ct. at 1793 (internal quotation marks and citation omitted); *Carbone*, 511 U.S. at 392; *Bacchus*, 468 U.S. at 272. In considering whether a law is motivated by simple economic protectionism, the analysis is not limited to legislative ends: If the means employed to achieve a legislative goal are themselves discriminatory, the legislation is subject to strict scrutiny regardless of whether its goal is non-protectionist or otherwise legitimate. *E.g.*, *Philadelphia*, 437 U.S. at 626-627 ("[T]he evil of protectionism can reside in legislative means as well as legislative ends," such that "whatever [the State's] purpose, it may not be accomplished by discriminating against articles of commerce coming from outside the State unless there is some reason, apart from their origin, to treat them differently.").

Kentucky seeks to avoid the consequences that flow from the reality that its tax scheme is motivated by simple economic protectionism by claiming that its scheme is justifiable as a revenue-generating measure. Kentucky does not argue the point openly because, as the Court has stated, "[b]y itself . . . revenue generation is not a local interest that can justify discrimination against interstate commerce." *Carbone*, 511 U.S. at 393. Instead, Kentucky baldly asserts that economic protectionism does not arise in "the provision of public works by sovereign States to their respective citizens." Pet. Br. 28. But again, the question is not whether Kentucky has the authority to issue bonds to raise funds for public purposes, but whether Kentucky may impose a discriminatory tax on out-of-state municipal bonds that impedes their sale in interstate

commerce. Whether economic protectionism arises when Kentucky issues a bond is irrelevant. It clearly arises as a result of Kentucky's distinct tax scheme.

Kentucky also contends that "[t]he evils of 'economic protectionism' are not manifested when the only 'in-state economic interest' is the taxing State itself. . . . There are no 'out-of-state competitors.'" Pet. Br. 28. The central fallacy of this argument is obvious: Kentucky is not the only one with an economic interest at stake, and its tax scheme clearly impacts out-of-state competitors; namely out-of-state issuers and sellers of municipal bonds that would otherwise compete on an equal basis for investment dollars in Kentucky. The intended purpose of Kentucky's scheme is to encourage the purchase of in-state municipal bonds by discouraging the purchase of out-of-state municipal bonds, and, thus, protect in-state economic interests at the expense of out-of-state economic interests. Indeed, Kentucky admits as much. Pet. Br. 12, 16. Accordingly, the scheme is unconstitutional.

3. Kentucky's law discriminates between similar financial commodities traded in the same market.

Kentucky argues that its scheme does not discriminate against interstate commerce on the theory that (1) its municipal bonds are not substantially similar to municipal bonds issued by other States because they differ with respect to use of proceeds and source of repayment, and (2) Kentucky is not substantially similar to any other bond issuer because no other issuer has the political responsibility for financing Kentucky projects. Pet. Br. 15, 17. This theory is meritless and Kentucky's reliance on *United Haulers* and *General Motors Corp. v. Tracy*, 519 U.S. 278 (1997), is misplaced.

Tracy involved a comparison of different entities serving two distinct and longstanding natural gas markets established with congressional approval—a non-captive market for private gas marketers that supplied "unbundled" gas, and a dis-

tinct, highly regulated captive market that supplied "bundled" gas. The Court explained that "when the allegedly competing entities provide different products, . . . there is a threshold question whether the companies are indeed similarly situated for constitutional purposes," and that "[t]his is so for the simple reason that the different entities . . . serve different *markets* and would continue to do so even in if the supposedly discriminatory burden were removed." 519 U.S. at 299 (emphasis supplied). Stating that the "dormant Commerce Clause protects markets and participants in markets," *id.* at 300, the Court assessed whether similar products were traded in the same market by considering the similarity of the products and entities allegedly in competition, the existence of a single, competitive market, the makeup of intended purchasers, and whether competition would be enhanced by eliminating the discrimination, *id.* at 299-304.

Kentucky's theory that its municipal bonds are "unique" fails under this analysis. Applying *Tracy*'s *market-based* criteria, Kentucky plainly *is* substantially similar to other bond-issuing States because it performs all the same general functions as other governmental issuers and competes with other States for capital in the same national municipal bond market. Moreover, Kentucky municipal bonds and those issued by other States are virtually identical investment commodities traded in the same national municipal bond market. They are subject to the same federal securities laws and are structured to qualify for the same federal income tax exemption regardless of their state of origin; they are rated by the same rating agencies and purchased by the same underwriters; they are sold to the same investors and compete for the same capital; and competition would be enhanced by elimination of the discrimination. Indeed, the only reason Kentucky enacted its discriminatory tax scheme is because the municipal bonds of

all States are common financial commodities, and Kentucky sought to *create* a distinction through its discriminatory tax.

Similarly, although some municipal bonds are owned by funds that hold only the bonds of one State, this is so solely because of the discriminatory tax laws such as the one at issue here. J. Hellerstein & W. Hellerstein, STATE TAXATION 4-110, ¶ 4.13[2][e] (3d ed. 1998) ("If ever one needed proof that such discriminatory state taxes Balkanize our national capital markets, one need look no further than the state-specific municipal bond funds that have arisen directly as a result of these discriminatory state taxes."). And the fact that the discriminatory laws themselves create a distinction or local practice of this kind cannot justify them. *West Lynn*, 512 U.S. at 205 ("If we were to accept these arguments, we would make a virtue of the vice that the rule against discrimination condemns. Preserving local industry by protecting it from the rigors of interstate competition is the hallmark of the economic protectionism that the Commerce Clause prohibits."). The only relevant difference between Kentucky municipal bonds and those of other States is that they originate from different places, *the* classic example of an impermissible basis for discrimination. *E.g.*, *Camps*, 520 U.S. at 583 n.16.

As the Court's precedents make plain, the proper analysis considers the impact of Kentucky's scheme on the municipal bond market and its participants as a whole, *West Lynn*, 512 U.S. at 202, not what Kentucky does with the proceeds of its bonds or whether Kentucky's tax scheme serves a public purpose. *Oregon Waste* 511 U.S. at 100 ("[T]he purpose of, or justification for, a law has no bearing on whether it is facially discriminatory."). As the Court explained in *Tracy*, the dormant Commerce Clause aims to protect the integrity of an *actual* market as defined by ordinary commercial considerations, 519 U.S. at 299-300, not the artificial factors that Kentucky proposes to escape scrutiny. Such factors as "use of

proceeds," "source of repayment," and "responsibility for funding public projects" have nothing to do with defining the municipal bond market as it exists in the real world or the impact of Kentucky's tax scheme. Nor should these factors have a role in the analysis. To protect the integrity of a free market (the aim of the Commerce Clause), the Court should examine the impact of Kentucky's scheme on the market itself, including other issuers and sellers across the market. Kentucky's proposed factors are irrelevant to that analysis.

Kentucky contends that its tax scheme is not discriminatory "because it treats all *issuers* other than Kentucky itself—public, private, in-state, out-of-state—exactly the same." Pet. Br. 21 (emphasis supplied). But this statement truncates the analysis in a way that renders it essentially meaningless. First, it improperly excludes Kentucky (and, by extension, its tax scheme). In comparison to Kentucky, other out-of-state issuers of municipal bonds (*i.e.*, other States and their subdivisions) encounter a barrier owing to Kentucky's tax law that Kentucky does not face (*i.e.*, an impediment to access to private investment dollars in Kentucky). Second, Kentucky's law has a greater impact on the market than its effects on issuers. For example, it affects other private sellers of out-of-state municipal bonds who also encounter a barrier to access to Kentucky investors. Again, the relevant analysis focuses on the impact of Kentucky's tax law on the breadth of the municipal bond market as a whole, including all of its participants. *West Lynn*, 512 U.S. at 202-03 (rejecting State's argument that "since the Massachusetts milk dealers who pay the order premiums are not competitors of the Massachusetts farmers, the pricing order imposes no discriminatory burden on commerce"; noting that "[f]or over 150 years, our cases have rightly concluded that the imposition of a differential burden on any part of the stream of commerce-from wholesaler to retailer to consumer-is invalid, because a burden

placed at any point will result in a disadvantage to the out-of-state producer") (citing, *inter alia*, *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 444, 448 (1827)).

It is also irrelevant if *some* in-state sellers of municipal bonds in Kentucky share the burden of Kentucky's discriminatory tax scheme with out-of-state sellers; for example, in-state sellers of out-of-state municipal bonds. *E.g.*, *Carbone*, 511 U.S. at 391 (ordinance "is no less discriminatory because in-state or in-town processors are also covered by the prohibition"); *Bacchus*, 468 U.S. at 271 ("the effect of the exemption is clearly discriminatory, in that it applies only to locally produced beverages even though it does not apply to all such products"); *Dean Milk Co. v. City of Madison*, 340 U.S. 349, 354 n.4 (1951) ("It is immaterial that Wisconsin milk from outside the Madison area is subjected to the same proscription as that moving in interstate commerce."). What matters is that out-of-state participants are disadvantaged and interstate commerce is impaired.

Kentucky's reliance on *United Haulers* also is misplaced. *United Haulers* provides no support for Kentucky's attempt to engraft onto dormant Commerce Clause analysis consideration of such factors as "use of proceeds," "source of repayment," and "responsibility for funding public projects." *United Haulers* also involved very different circumstances. There, the Court found that an in-state *public* trash facility was not substantially similar to any in-state or out-of-state *private* trash facilities and, therefore, an ordinance that favored use of the public facility was not discriminatory. In contrast, the discrimination here involves the disparate treatment of municipal bonds issued by similarly situated *public* entities (States) and traded by similarly situated *private* sellers and investors (underwriters, mutual funds, and other individual and corporate investors), all participating in the same *private* national market. The ordinance at issue in *United*

Haulers discriminated in favor of a local *public* business and against *all private* businesses, irrespective of whether they were located in-state or out-of-state. Here, Kentucky's tax scheme discriminates in favor of one public issuer against other public issuers and in favor of private ownership of in-state bonds against private ownership of out-of-state bonds. It thus bears *all* the hallmarks of a proscribed tariff designed to keep out commodities issued by other States and sold by out-of-state sellers in private interstate commerce.

4. Kentucky does not and cannot show that it has no other means to advance a legitimate purpose behind its discriminatory tax scheme.

To save a law that discriminates against out-of-state interests in interstate commerce, the State bears the burden of showing that it "has no other means to advance a legitimate local purpose." *United Haulers*, 127 S. Ct. at 1793. "[T]his is an extremely difficult burden, so heavy that facial discrimination by itself may be a fatal defect." *Oregon Waste*, 511 U.S. at 101 (1994) (internal quotation marks and citations omitted). Kentucky does not attempt to meet its burden and has thus waived its opportunity to do so. *Camps*, 520 U.S. at 582 ("[P]erhaps realizing the weight of its burden, the Town has made no effort to defend the statute under the per se rule, and so we do not address this question."); *Fulton*, 516 U.S. at 333-34. Kentucky simply states that its discriminatory tax scheme enables it to generate revenues. Again, revenue-generation is not a sufficient basis to justify discrimination against interstate commerce. *United Haulers*, 127 S. Ct. at 1798. If the law were otherwise, virtually every discriminatory tax scheme would be permissible because all tax schemes are designed to generate revenue. *Cf. Carbone*, 511 U.S. at 393-94 ("Otherwise States could impose discriminatory taxes against solid waste originating outside the State.").

B. Kentucky's Discriminatory Tax Scheme Violates The Purposes Of The Dormant Commerce Clause.

1. Kentucky's tax scheme fosters economic balkanization and retaliation.

A key goal of the Commerce Clause was the creation of a "unitary national market," *West Lynn*, 512 U.S. at 193, characterized by "free access to every market in the Nation," *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 539 (1949), and "an area of free trade among the several States," *Boston Stock Exchange*, 429 U.S. at 328 (internal quotation marks and citation omitted). Kentucky's tax scheme frustrates this goal by creating a barrier to the sale of out-of-state municipal bonds in Kentucky. Out-of-state issuers and sellers of municipal bonds should be free to sell out-of-state bonds to Kentucky citizens, and Kentucky citizens should not be penalized for engaging in interstate commerce by purchasing out-of-state municipal bonds. *Id.* at 335 ("This free trade purpose is not confined to the freedom to trade with only one State; it is a freedom to trade with any State, to engage in commerce across all state boundaries.").

One recognized benefit of free trade is the avoidance of ongoing, low-level "trade wars" that emerge when States are forced to retaliate against their neighbors' discriminatory, protectionist laws. *Granholm*, 544 U.S. at 473; *Carbone*, 511 U.S. at 390 ("The central rationale for the rule against discrimination is to prohibit state or municipal laws whose object is local economic protectionism, laws that would excite those jealousies and retaliatory measures the Constitution was designed to prevent."). Kentucky's scheme, combined with the similar laws of other States, has precisely the effect of fostering an ongoing, low level trade war, and is a textbook example of a law the Commerce Clause was intended to prevent. *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179-80 (1995) (explaining that the Commerce

Clause contains "a contain a further, negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject" and that this command "serve[s] the Commerce Clause's purpose of preventing a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole, as it would do if it were free to place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear").

Utah's similar tax law vividly illustrates the retaliatory nature of the discriminatory tax scheme challenged here. Utah does not tax income earned from in-state or out-of-state municipal bonds, *unless* the out-of-state bond was issued by a State that imposes a tax on income from Utah bonds. Utah Code Ann. § 59-10-114(6)(a) (2007).[3] Obviously, Utah's tax retaliates against other States that tax the income from Utah's municipal bonds, but not their own.

Kentucky argues that the "free market rationale is attenuated here," as the "sovereign States are not farmers or craftsmen attempting to provide goods and services to the citizens of their sister States," and that a consumer of public goods provided and financed by Kentucky can never "'look to . . . free competition' from other States to provide education,

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[3] While Utah was considering whether to implement a tax on out-of-state bonds, a Salt Lake City newspaper quoted the Assistant Majority Whip in the Utah House of Representatives as saying, "As I see it, what's the basis for Utah to encourage investment in other states? If you live in Michigan or Minnesota there is no incentive to buy muni bonds outside your state. But in Utah there is a disincentive to buy local bonds. In order to make Utah bonds more attractive, you have to provide a greater rate of return or provide a more secure investment. But if both bonds have a AAA rating, the only way to make the Utah bond competitive is to pay a higher interest rate." Max Knudson, *Veto of "Muni" Bill Urged*, DESERET NEWS, March 12, 2001, at B08.

roads, sewers, prisons, and bridges for Kentucky." Pet. Br. 27-28. But the relevant commodity is not any public infrastructure or service, but municipal bonds that are bought, sold, and traded in interstate commerce. Again, Kentucky confuses its power to borrow money from private investors by issuing bonds to finance public services with its authority to tax bonds traded in interstate commerce. Kentucky's tax scheme discriminates against out-of-state municipal bonds, and what Kentucky does with the bond proceeds is irrelevant.

2. Kentucky's discriminatory tax scheme hoards private capital and impedes interstate commerce.

The Court has long recognized that the Commerce Clause proscribes the hoarding of local resources to the detriment of a cohesive and equitable market economy. *Baldwin v. Fish & Game Comm'n*, 436 U.S. 371, 385-86 (1978); *West v. Kansas Natural Gas Co.*, 221 U.S. 229, 255 (1911). Kentucky's tax scheme is intended to, and has the effect of, hoarding available private investor capital in Kentucky and impeding the free flow of capital in interstate commerce. Kentucky's scheme thus violates this purpose of the Commerce Clause and is unconstitutional. *Fulton*, 516 U.S. at 343 (rejecting States' creation of preferential trade areas as constitutionally impermissible); *Dean Milk*, 340 U.S. at 356 (striking down discriminatory ordinance, stating that it "would invite a multiplication of preferential trade areas destructive of the very purpose of the Commerce Clause," and concluding that, under the circumstances, "the regulation must yield to the principle that 'one state in its dealings with another may not place itself in a position of economic isolation'") (quoting *G.A.F. Seelig, Inc.*, 294 U.S. at 527).

3. Kentucky's tax scheme is undemocratic.

A key concern of the Court's dormant Commerce Clause jurisprudence is the avoidance of discriminatory tax laws that place the burden of the discrimination on those who cannot

vote out of office those who have imposed it. *United Haulers*, 127 S. Ct. at 1797. This concern is rooted in the ancient principle of no taxation without representation. *E.g.*, THE DECLARATION OF INDEPENDENCE para. 19 (U.S. 1776). In granting Congress the power to regulate interstate commerce, the Framers clearly intended to deny the States the power to impair interstate commerce with tariff-like taxation that burdened those who could not protest: "A very material object of this power was the relief of the States which import and export through other states from the improper contributions levied on them by the latter." THE FEDERALIST NO. 42, at 235-36 (J. Madison). Kentucky's discriminatory tax scheme plainly burdens out-of-state issuers (who have no recourse but to retaliate with discriminatory taxes of their own) and out-of-state sellers (who have no ability, through exercise of the franchise, to protest the burden placed upon them). As such, it is profoundly undemocratic and unconstitutional.

C. Kentucky's Discriminatory Tax Scheme Imposes Additional Harms Antithetical To A Free Market.

Kentucky's discriminatory tax scheme imposes a number of other harms, chief among them the harm of permitting a participant in the national municipal bond market to distort that market and create inefficiencies. Among other distortions, discriminatory tax schemes like the one at issue here have fostered the growth of funds that hold only the municipal bonds of a single state. As compared to national tax-exempt bonds funds, these tend to be higher risk and higher cost. Joel Michael, *Department of Revenue of Kentucky v. Davis: Implications for State Tax Policy and Dormant Commerce Clause Doctrine*, 45 STATE TAX NOTES (forthcoming 2007) (as compared to single-state bond funds, national tax-exempt funds are geographically diversified and have lower costs). Single-state funds are higher risk because they undermine the cardinal diversification principle, and tend to be

higher cost because of the loss of economies of scale. Discriminatory tax laws thus foster comparatively risky, expensive investment vehicles.

Kentucky's tax scheme also harms its own interests. Kentucky contends that its scheme boosts revenues by reducing borrowing costs (*i.e.*, the interest it pays on its bonds). It reasons that, by not taxing the income its citizens earn on Kentucky bonds, it can pay a below-market interest rate and still attract Kentucky investors who benefit from the bonds' tax-exempt status. Pet. Br. 24; NAST Am. Br. 29; SIMFA Am. Br. 7. But as Kentucky concedes, it also loses the tax revenue it would otherwise earn if it its bonds were not tax-exempt. Pet. Br. 23. And it is a documented phenomenon that the loss of revenue in all likelihood more than offsets the lower interest payments. Brian D. Galle & Ethan Yale, *Can Discriminatory State Taxation of Municipal Bonds be Justified? Thoughts on the Davis Topside Briefs*, 117 TAX NOTES (forthcoming October 2007). Indeed, studies indicate that the tax exemption *costs* States significant money. C. Steven Cole *et al.*, *The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields*, J. FIN. & STRATEGIC DECISIONS, Summer 1994 at 72-73, 75; Mary E. Loverly & Michael J. Wasylenko, *State Taxation of Interest Income and Municipal Borrowing Costs*, 45 NAT. TAX J. 37, 48-51 (1992).[4] Because States appear to lose more revenue via discriminatory tax exemptions than they gain by borrowing at

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[4] The Cole study of 1985-1987 found that "the cost to the states in the form of lost tax revenues is significantly greater than the estimated benefit of reduced interest costs to in-state issuers." Cole at 73. Loverly & Wasylenko estimate that in the first year of repayment on a hypothetical Kentucky bond, *the revenue lost due to the tax exemption was nearly double the amount of the revenue saved by borrowing at the lowered interest rate*. Loverly at 50.

lower rates, it is unlikely that revenue-raising is the true motivation behind these schemes. Instead, these tax schemes are protectionist measures enacted in an ongoing retaliatory trade war. The States would all be better off if *none* of them had discriminatory tax laws, but so long as *one* State has enacted such a law, others are compelled to follow.

If just one State enacts a discriminatory tax law like Kentucky's, and the others treat all bonds as tax-exempt, the one State that discriminates benefits *both* from selling its bonds freely in the national interstate municipal bond market while at the same time blocking other States' access to its residents. The result is a classic "race to the bottom." Where all States have the same discriminatory law, the playing field is relatively equalized, but the States suffer collectively a net harm because the loss of revenue from offering a tax exemption to their residents more than offsets the lower interest payments that they pay on their bonds. The cure here is to remove the discrimination by enforcing the dormant Commerce Clause.

D. Kentucky's Taxation Scheme Cannot Be Sustained On Any Theory Of Publicly Owned Business.

Kentucky's contention that *United Haulers* "is controlling here," Pet. Br. 21, is wrong. *United Haulers* involved very different circumstances and a fundamentally different analysis. *United Haulers* involved a state-owned local *business* established in response to public demand to alleviate pressing social problems. 127 S. Ct. at 1791 (noting health, safety, and racketeering problems). This case involves a state *tax* scheme designed to generate revenue for Kentucky that applies to private property traded in a national private market that Kentucky does not own. The distinction between a State's use of its police power to remedy a perceived problem involving local health and safety (the issue in *United Haulers*), and its power to regulate interstate commerce through a discriminatory tax (the issue here) is constitutionally signifi-

cant and analytically distinct. *E.g.*, *West Lynn*, 512 U.S. at 206 n.21 ("This distinction between the power of the State to shelter its people from menaces to their health or safety and from fraud, even when those dangers emanate from interstate commerce, and its lack of power to retard, burden or constrict the flow of such commerce for their economic advantage, is one deeply rooted in both our history and our law.") (quoting *Hood*, 336 U.S. at 533). Moreover, the question presented here—whether a State may use its *tax* power to restrict interstate commerce by discriminating against the issuance, purchase, and sale of out-of-state municipal bonds in the national market—was not at issue in *United Haulers*. Further, *United Haulers* did not involve a facially discriminatory tax scheme; this case does. Here, the Court's dormant Commerce Clause precedents in the tax context apply in full force, and these decisions clearly require the conclusion that a State may *not* use its tax power in the manner at issue in this case.

This case also differs from *United Haulers* with respect to political accountability concerns. In *United Haulers*, the Court stated that "the most palpable harm imposed by the ordinances—more expensive trash removal—is likely to fall upon the very people who voted for the laws." 127 S. Ct. at 1797. Not so here. The States with which Kentucky competes for capital in the national municipal bond market have no voice in the Kentucky legislature; nor do other sellers of municipal bonds from other States who wish to sell them to Kentucky citizens. Yet, these out-of-state interests suffer the most palpable harm from Kentucky's tax scheme, exacerbated because almost all States have retaliated against each other by enacting similar discriminatory laws, thus distorting and impairing the market from multiple source points.

Kentucky contends that this case presents no political accountability issue on the theory that the taxpayers who must pay the tax on interest from out-of-state municipal bonds are

represented in the Kentucky legislature. Not so. To begin with, the Court has explicitly rejected this argument:

> This argument, if accepted, would undermine almost every discriminatory tax case. State taxes are ordinarily paid by in-state businesses and consumers, yet if they discriminate against out-of-state products, they are unconstitutional. The idea that a discriminatory tax does not interfere with interstate commerce "merely because the burden of the tax was borne by consumers" in the taxing State was thoroughly repudiated in [*Bacchus*]. The cost of a tariff is also borne primarily by local consumers, yet a tariff is the paradigmatic Commerce Clause violation. . . . .

West Lynn, 512 U.S. at 203-04 (internal citations omitted). The Court concluded in *West Lynn* that "[t]he obvious impact of the order [challenged in that case] on out-of-state production demonstrates that it is simply wrong to assume that the pricing order burdens only Massachusetts consumers and dealers." *Id.* The same is true in this case.

Further, the "most palpable harm" here cannot be said to fall on Kentucky taxpayers who pay a tax on interest from out-of-state municipal bonds. The tax scheme itself is designed to reduce the number of such taxpayers, and these taxpayers are unlikely to complain because they can avoid the tax by purchasing in-state bonds. Here, out-of-state issuers and sellers bear the most palpable harm, and they have no voice in the Kentucky legislature.

Nor do out-of-state issuers and sellers have any other surrogate in Kentucky. In *United Haulers*, the interests of in-state private businesses were largely aligned with those of out-of-state private businesses (*e.g.*, they shared the same cost concerns related to tipping fees). 127 S. Ct. at 1797. Thus, local businesses could serve as a surrogate for out-of-state private businesses adversely affected by the ordinances

and could use established political channels to advocate for legislative change. *Id.* On those facts, the Court stated that there was "no reason to step in and hand local businesses a victory they could not obtain through the political process." *Id.* The opposite is true here. No local *public* business in Kentucky competes with the Commonwealth in the municipal bond market. And *private* bond issuers have no incentive to complain about Kentucky's scheme because they do not compete with Kentucky in the tax-exempt municipal bond market either.[5] Thus, in contrast to *United Haulers*, there is no "powerful safeguard against legislative abuse," and the burdens created by Kentucky's scheme are "unlikely to be alleviated by the operation of political restraints normally exerted when interests within the state are affected." 127 S. Ct. at 1797; *see West Lynn*, 512 U.S. at 200-01 & n.17. In this case, Kentucky's law creates a nearly perfect externality by placing its most palpable costs outside its borders.

Kentucky's argument that its tax scheme cannot be unconstitutional because its purpose is to benefit itself, Pet. Br. 32, also has no basis is law or logic. Once again, Kentucky errs by focusing on its status and authority as a bond-issuer and provider of public services to Kentucky citizens. But the

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[5] That interest on both in-state and out-of-state private bonds is taxed under Kentucky's scheme is of no moment. Interest on out-of-state municipal bonds is exempt from federal taxation. The same is not true of private bonds. Private bond issuers do not compete with the States in the market at issue here (the tax-exempt municipal bond market) and to the extent that private bond issuers may be said to be disadvantaged by the existence of tax-exemptions for municipal bonds, that disadvantage exists in any event by virtue of the federal tax exemption, which also is much larger than the exemption provided by Kentucky's scheme. Yale & Galle, 115 TAX NOTES at 1043 ("[T]he municipal bond market is sufficiently distinct from the taxable bond market that competition between municipal and taxable bonds is not constitutionally significant.").

question is not whether Kentucky may invoke its police power to issue and repay municipal bonds for some public purpose. Under the Court's discriminatory tax precedents, the analysis focuses on the impact of Kentucky's discriminatory tax scheme on the interstate municipal bond market and its other participants. Nothing in *United Haulers* changes this analysis in cases, such as this one, involving a facially discriminatory tax that functions as a tariff.

Moreover, *every* tax, and every tax exemption or incentive, is intended to favor the State that imposes it. If accepted, Kentucky's argument would justify every kind of discriminatory tax, including tariffs. Further, Kentucky's local interest argument ignores the fact that its discriminatory tax impairs the ability of its sister States to provide goods and services to their citizens by manipulating the national municipal bond market. Kentucky's law cannot be considered in a vacuum, and its impact must be taken into account. The circumstances of this case were not present in *United Haulers*, and Kentucky cannot rely on either *United Haulers* or any principle of local interest to justify its law.

Respondents in *United Haulers* urged an "approach of treating public and private entities the same." 127 S. Ct. at 1797. Respondents here seek only to ensure that financial commodities issued by similarly situated public entities and traded in the private bond market are taxed or not taxed equally. The disparate-impact analysis of *United Haulers* does not apply to Kentucky's facially discriminatory tax scheme. A judgment affirming the decision below will not lead to "unprecedented and unbounded interference by the courts," *id.*, as such a judgment falls well within the boundaries of the Court's precedents and is necessary to preserve the integrity of the municipal bond market.

E. The Market Participant Doctrine Does Not Apply, And Kentucky's Subsidy Analogy Is Misplaced.

The Court has recognized that a State acting as if it were a private party in the market may exercise "the long recognized right of trader or manufacturer, engaged in an entirely private business, freely to exercise [its] own independent discretion as to parties with whom [it] will deal." *Reeves, Inc. v. Stake*, 447 U.S. 429, 438-39 (1980) (internal quotation marks and citation omitted). Consistent with this rationale, the Court has confined the market participation doctrine to situations in which a State participates in the market on the same terms as a private party and has held that the doctrine does *not* apply where, as here, a State imposes conditions only a state actor could impose. The Court has concluded that a State acts as a market participant only when "burdened with the same restrictions imposed on private market participants," *id.* at 438, and specifically held that the doctrine cannot validate a tax exemption because "[a] tax exemption is not the sort of direct state involvement in the market that falls within the market-participation doctrine," *Camps*, 520 U.S. at 593.

Kentucky argues that the Court should disregard this limitation on the theory that it could have encouraged the purchase of its bonds some other way (such as through a subsidy) and, thus, it makes no difference that it encourages the purchase of its bonds through a tax scheme. The Court has rejected this argument, and has explicitly held that a State cannot justify a discriminatory tax on the theory that it could have accomplished the same purpose with a subsidy. *Limbach*, 486 U.S. at 277 ("The Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description in connection with the State's regulation of interstate commerce. Direct subsidization of domestic industry does not

ordinarily run afoul of that prohibition; discriminatory taxation of out-of-state manufacturers does.").

This is a tax case, and the Court's precedents direct that Kentucky's use of its tax power to discriminate against out-of-state bonds is constitutionally significant and is evaluated under the constitutional rules applicable to exercise of the tax power. That Kentucky might have encouraged the purchase of its municipal bonds in some other way (*e.g.*, through a subsidy or by restricting the sale of its bonds to its residents) that might be evaluated under other constitutional rules is irrelevant and does not justify application of the market participant doctrine. In *Limbach*, for example, the Court rejected Ohio's argument that the market participant doctrine applied because its facially discriminatory tax scheme was like a subsidy. The Court reasoned that "[t]he Ohio action ultimately at issue is neither its purchase nor its sale of ethanol, but its assessment and computation of taxes—a primeval governmental activity." 486 U.S. at 277. While the scheme had "the purpose and effect of subsidizing a particular [in-state] industry," it imposed a tax penalty on the favored industry's competitors in transactions in which Ohio was not involved, treatment that "cannot plausibly be analogized to the activity of a private purchaser." *Id.* at 278. The Court thus held unanimously that "[t]he market-participant doctrine has no application here." *Id.*

In *Camps*, the Court rejected Maine's invocation of the market participant doctrine for the same reason. Maine provided local tax relief to children's summer camps that served primarily in-state residents, but not to camps that served primarily out-of-state individuals. Maine argued that its tax scheme was, in effect, a way to buy services for its residents. Although the Court was divided on the ultimate result in the case, no justice suggested that the market participant doctrine applied. *See* 520 U.S. at 607 (Scalia, J., dissenting). As in

Limbach, Maine's scheme may have had "the purpose and effect of subsidizing" camps that provided services to Maine resident children, but it did so by penalizing camps that provided services to other children, even though Maine did not contend that it engaged in transactions with those disfavored camps. "The activity of a private purchaser" could not have imposed a similar penalty. A private charity certainly could give money to camps serving Maine children (and so could Maine) but a private charity with no connection to the transaction could not send a bill to camps serving out-of-state children, which is what Maine and its municipal entities actually did. The Court thus rejected the notion that "whenever a State provides a discriminatory tax abatement it is 'purchasing' some service in its proprietary capacity." *Id.* at 594.

Kentucky's assertion that it is "just" using its tax power to fix the terms of its bonds, Pet. Br. 42, 44-45, also is unavailing. First, Kentucky accomplishes its goal, not by altering the terms of its own bonds, but by taxing other States' bonds. The Court's precedents reject Kentucky's theory and focus the analysis on the impact of its tax scheme. Second, Kentucky is no more "just" fixing the terms of its bonds than Alaska was "just" determining the terms of the sale of state-owned timber by requiring that all such timber be processed in Alaska. *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 96-99 (1984) (plurality). That a State issues or originates a commodity does not mean that the State is free to restrict interstate commerce by impairing the subsequent private trade of that commodity, *id.* at 96, let alone the same commodity issued by others.

A State's use of its tax power implicates all the restrictions incident to that power, and allowing the market participant doctrine to shield discrimination through taxation "would swallow the rule against discriminatory tax schemes." *Camps*, 520 U.S. at 594. As in *Limbach*, the Kentucky action

"ultimately at issue is neither its purchase nor its sale of [its own bonds], but its assessment and computation of taxes [on other bonds]—a primeval governmental activity." 486 U.S. at 277. The scheme is neither a subsidy nor any other market activity that a private party could perform. The market participant doctrine, and its underlying principles, do not apply.

F. Kentucky's Reliance On *Bonaparte* And Principles Of Sovereignty Are Misplaced.

Kentucky errs in arguing that *Bonaparte v. Tax Court*, 104 U.S. (14 Otto) 592 (1881), requires reversal. *Bonaparte* holds that a State may tax income generated by property (securities) owned by a resident taxpayer even though the property originated from another State and would be taxed differently (*i.e.*, not at all) if the taxpayer resided elsewhere. The case did not decide the very different question presented here: whether the same State may tax differently income generated by property (securities) of a resident taxpayer based on whether the property originated in- or out-of-state.

In *Bonaparte*, a Maryland resident claimed an exemption for interest earned on state and municipal "stocks" issued outside of Maryland on the basis that they were of "public character" and were exempt from taxation by the laws of their issuing States. 104 U.S. at 592. The applicable Maryland tax statute did not, however, exempt interest income on publicly issued debt, whether issued in Maryland or a sister State. Brief for Plaintiff in Error 1-4 ("Pl. Br.") (quoting the Maryland tax statute). Upon Maryland's denial of the claimed exemption, the plaintiff sued, challenging the denial. 104 U.S. at 592. The trial court upheld her challenge, but the appellate court reversed, and the plaintiff appealed to this Court, alleging a violation of the Full Faith and Credit Clause. *Id.* The Court upheld the tax, reasoning that, even though a citizen of a State may invest in debt issued by other

States, the citizen is still "a resident of the State in which he dwells" and subject to its tax power. *Id.* at 595.

The question presented in this case could not possibly have been before the Court in *Bonaparte* because Maryland did not then have a discriminatory tax scheme similar to Kentucky's. The Maryland statute assessed taxes on, *inter alia*, "all shares of stock . . . owned by residents of this State," "all bonds made by . . . any other State," and "all property of every kind, nature and description within this State," except for an exclusive list of property exempt from the tax. Pl. Br. at 2. Notably absent from the list were *any* publicly issued debt instruments, including any issued within Maryland. *Id.* Thus, under the statute, public bonds issued by Maryland *and* its sister States were equally taxable. Moreover, nothing in the record suggests that the plaintiff sought, received, or was entitled to an exemption for interest on any Maryland bond. *Id.* at 1-6; Brief of Charles J.M. Gwinn, Attorney General of Maryland, for the Defendant in Error at 1-6.

That *Bonaparte* neither considered nor analyzed the dormant Commerce Clause is reinforced by the Court's subsequent treatment of the case. Despite Kentucky's claim that *Bonaparte*'s "sweeping declaration . . . frame[s] this dormant Commerce Clause case," Pet. Br. 14, the Court has not once referred to *Bonaparte* in the context of a dormant Commerce Clause challenge. Moreover, to the extent *Bonaparte* is applicable here, it undermines Kentucky's position. The Court observed that, when a State seeks to borrow funds, "it is compelled to go into the market as a borrower subject to the same disabilities in this particular as individuals." 104 U.S. at 595. Kentucky does *not* seek to "go into the market" with "the same disabilities" as a private party, but rather armed with its coercive tax power to discourage the purchase of out-of-state municipal bonds.

Kentucky's "sovereignty" arguments fare no better. Relying on *Bonaparte*, *Georgia v. Chattanooga*, 264 U.S. 472 (1994), and *Nevada v. Hall*, 440 U.S. 410 (1979), Kentucky argues that an "essential attribute" of state sovereignty is "the mutual exclusivity of the sovereignty of the States vis-à-vis each other." Pet. Br. 31. But these cases concern extraterritorial application of state laws, a point not at issue here.[6] The question before the Court is not whether Kentucky may tax interest income derived from the municipal bonds of other States, but whether Kentucky may tax income earned on other States' bonds while simultaneously exempting income earned on its own bonds. Also inapposite are the "federalism cases" Kentucky relies on, each of which involves issues that are irrelevant to the question presented here. *E.g.*, *Federal Maritime Comm'n v. South Carolina State Ports Auth.*, 535 U.S. 743, 751-52 (2002) (concerning whether a State's sovereign immunity bars a federal agency from adjudicating private suits against States; holding that it did, as "[a]n integral component of [the] 'residuary and inviolable sovereignty' retained by the States is their immunity from private suits")

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[6] *Georgia*, 264 U.S. at 480 ("Land acquired by one state in another state is held subject to the laws of the latter and to all the incidents of private ownership."); *Nevada*, 440 U.S. at 426-27 ("In this Nation, each sovereign governs only with the consent of the governed. . . if a federal court were to hold . . . that California is not free in this case to enforce its policy [despite Nevada's non-conforming policy], that holding would constitute the real intrusion on the sovereignty of the States. . . in our Union."); *Bonaparte*, 104 U.S. at 594 ("No State can legislate except with reference to its own jurisdiction."). *The Schooner Exchange v. McFadden*, 11 U.S. 116 (1812), did not consider the sovereignty of a State in relation to other States, but the sovereignty of the Nation in relation to other nations, and held that our Nation's absolute autonomy and territorial jurisdiction must yield to that of another nation only where necessary to promote mutual trade intercourse. 11 U.S. at 136-38.

(internal quotations omitted); *Printz v. United States*, 521 U.S. 898, 919-22 (1997) (discussing separation of federal and state powers, and the inability of the federal government to impose obligations on state offices to carry out federal laws because of the "double security" afforded by federalism); *Garcia v. San Antonio Metropolitan Transit Auth.*, 469 U.S. 528, 553-55 (1985) (addressing the ability of *Congress* to enforce, via the Commerce Clause, a *federal* statute against a State; holding enforcement constitutional because federalism is safeguarded through the *national* political process).

Kentucky's tax scheme violates the dormant Commerce Clause. It cannot be saved on the basis of the sovereignty, extraterritoriality, and federalism cases cited by Kentucky in its defense. *See Nevada*, 440 U.S. at 425 ("While sovereign nations are free to levy discriminatory taxes on the goods of other nations or to bar their entry altogether, the *States of the Union are not*. . . . [O]urs is not a union of 50 wholly independent sovereigns.") (emphasis supplied).

G. Kentucky's Scheme Fails Under *Pike*.

If the Court were to determine that Kentucky's tax scheme is non-discriminatory, that would not end the matter. The law then would be analyzed under *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970), holding that a nondiscriminatory statute will be upheld "unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefit." 397 U.S. at 142. The lower courts did not conduct the relevant analysis, which involves questions of fact, and Kentucky does not address the issue here.[7] To the

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[7] Although some of Kentucky's *amici* contend that Kentucky enjoys benefits from the relevant tax scheme that outweigh its burdens, they offer no evidence to support their argument, only bald assertions of benefit, unaccompanied by any real analysis of burden. *E.g.*, GFOA. Br. 23.

extent the Court addresses any aspect of the *Pike* test, the tax scheme plainly fails the test. As discussed, the scheme burdens excessively interstate commerce, is counter-productive, and the only reason Kentucky enacted it is that other States have done so. Alternatively, if the Court were to determine that Kentucky's tax scheme is non-discriminatory, the Court should remand for consideration of the *Pike* analysis.

H. None Of The Other Arguments Made By Kentucky And Its *Amici* Require Reversal.

1. Congressional inaction does not provide a basis for reversal.

Kentucky and its *amici* argue that congressional inaction constitutes congressional approval of the discriminatory bond taxation schemes enacted by most States. The argument is meritless. As one *amicus* brief admits, "this Court is generally reluctant to draw inferences from congressional silence." GFOA Br. 4. Moreover, congressional inaction provides no basis for the Court to refrain from judicial intervention, particularly where, as here, the "constitutional . . . mandate for judicial choice is clear." *Tracy*, 519 U.S. at 309.

Kentucky asserts that Congress has had occasion to prohibit discriminatory taxation of out-of-state municipal bonds and did nothing. It points to a 1959 congressional act that commissioned a study of general tax matters having an impact on business activities in interstate commerce, and suggests that the resulting report, and summary of statutes included therein, demonstrates congressional acceptance of discriminatory municipal bond tax schemes. Pet. Br. 37-39. Kentucky ignores that the act authorizing the study shows that Congress was focused on businesses facing tax obligations in various States, not discriminatory taxes on municipal bonds. It also misrepresents and exaggerates the 1964 report of the Special Subcommittee on State Taxation of Interstate Commerce (the "Subcommittee"). The Subcommittee stud-

ied the tax areas "with which Congress was mainly concerned in authorizing the project: Income taxes and sales and use taxes as they apply to businesses selling goods in interstate commerce." H.R. REP. NO. 88-1480, vol. 1, at 14 (1964). It explicitly excluded personal income taxes from its analysis, as well as income taxes of other entities that might be impacted by the discriminatory tax schemes at issue here. H.R. REP. NO. 89-952, vol. 4, Part VI, at 1163 (1965) ("The specific proposals set forth in this chapter do not apply to . . . financial institutions, investment companies, and holding companies. Nor do they apply to income taxes imposed on individuals or unincorporated businesses."). These studies and reports do not demonstrate congressional acquiescence, let alone the kind of congressional approval necessary to save Kentucky's discriminatory scheme.

2. The fact that refunds may be warranted does not provide a basis for reversal.

Kentucky argues that a decision of this Court that affirms the decision below and applies retroactively would pose a hardship because taxpayers would demand refunds. States routinely make such arguments and the Court routinely rejects them.[8] Where a State's tax policies "violate[] constitu-

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[8] In *South Carolina v. Baker*, 485 U.S. 505 (1988), the Court upheld a federal tax on interest from certain state-issued bonds, despite South Carolina's arguments, similar to Kentucky's arguments here, that upholding the federal tax statute "would force South Carolina to pay approximately 3% to 5% more by way of interest rates." *South Carolina v. Baker*, Compl., Ex. B., ¶ 9 (Feb. 7, 1983) (Aff. of Grady L. Patterson). South Carolina argued that if the Court upheld the statute, thus requiring States to issue registered bonds or forego the federal tax exemption, it could not "withstand without severe hardship the potential loss of money under either alternative. The fact that all fifty States will also be immediately economically burdened to a significant extent . . . compounds the urgency." Pl. Mot. For Leave to File Compl. and Supporting Br. 40-41.

tional norms well established under existing precedent," the burden a State faces in providing relief for those violations is "largely irrelevant." *American Trucking Ass'ns, Inc. v. Smith*, 496 U.S. 167, 183 (1990). In *Harper v. Virginia Dep't of Tax'n*, 509 U.S. 86 (1993), over 40 States signed an *amicus* brief urging the Court to affirm the decision of the court below, in part, because a reversal order that applied retroactively would burden the public fisc. The Court declined. 509 U.S. at 95 n.9 ("Federal law applicable to a particular case does not turn on 'whether [litigants] actually relied on [an] old rule [or] how they would suffer from retroactive application' of a new one."). Clearly, Kentucky's interest in avoiding paying refunds "does not justify a refusal to provide relief." *McKesson Corp v. Division of Alcoholic Bevs. & Tobacco*, 496 U.S. 18, 50 (1990). Any potential hardship that a State may face in providing tax refunds does not excuse the State from its obligation to "provide meaningful backward-looking relief to rectify any unconstitutional deprivation." *Harper*, 509 U.S. at 101 (internal quotation omitted); *see Reich v. Collins*, 513 U.S. 106, 114 (1994).

3. Kentucky's parade of economic horribles is overblown and does not provide a basis for reversal.

Kentucky and its *amici* claim that affirmance would cause financial problems in the market. *E.g.* Pet. Br. 36; Churchill Br. 18-19; Dupree Br. 6-7; GFOA Br. 8-10. One Kentucky *amicus*, however, states on its website that an affirmance would have relatively little effect, which is a far more accurate assessment.[9] As the statement indicates, although an af-

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[9] Churchill Tax-Free Fund of Ky., Prospectus Supp. & Statement of Additional Information, April 30, 2007, supplemented June 1, 2007, *available at http://www.aquilafunds.com/Download/CHURCHILL%20TAX-FREE%20A&C.pdf*

firmance may have some small effect on the price of some bonds, the market will adjust quickly. Affirmance will not cause any State to default on its bonds, will not cause the municipal bond market to collapse, and will not require any State to forego repairing its roads or building its schools. It will simply put an end to Kentucky's discriminatory, inefficient, and counter-productive tax scheme. Absent discrimination, investment diversification will be easier. Likewise, smaller States that lack the same access to capital as New York or California will likely have an *easier* time finding purchasers for their bonds. James F. Blumstein, *Some Intersections of the Negative Commerce Clause and the New Federalism: The Case of Discriminatory State Income Tax Treatment of Out-of-State Tax-Exempt Bonds*, 31 VAND. L. REV. 473, 546 (April 1978) ("Absent discrimination, relatively capital-scarce states, whose bonds might be more attractive when viewed from a 'tax-neutral' perspective, could more easily compete for capital funds concentrated in large commercial areas.") (citation omitted). States that exempt from taxation interest on their own bonds may simply raise interest rates to offset the loss of the exemption. Robert Zipf, HOW MUNICIPAL BONDS WORK 75 (1989). This could actually lead to increased net revenue. Municipal bonds would still be attractive investments because of the federal tax exemption, which is almost always much larger than the state exemption. And changes in federal tax laws altering marginal rates and related bond values historically have had a far greater market impact than the elimination of the protectionist tax schemes implicated here, without any of the dire consequences Kentucky and its *amici* predict. Kentucky objects to changing the status quo because it reflects a widespread practice. But asking the Court to disregard a constitutional violation because it is widespread is perverse. None of Kentucky's arguments justify what it seeks.

4. The States have long been aware that their discriminatory municipal bond taxation schemes are potentially unconstitutional and Kentucky's reliance argument provides no basis for reversal.

Kentucky argues that "substantial reliance interests" counsel in favor of reversing the decision below. Pet. Br. 35. Kentucky offers no support for this assertion and it provides no ground for reversal in any event. States have long been aware of the problem. Commentators pointed it out decades ago, *see* Blumstein, 31 VAND. L. REV. 473 (identifying the problem thirty years ago), and State legislatures have actually considered the matter. For example, in March 1995, Minnesota Representative Rest submitted an amendment to Minnesota's tax statute, Minn. Stat. Ann. § 290.01, proposing to repeal the individual income tax exemption for municipal bond interest on in-state bonds. Representative Rest testified at a hearing that the rationale for the repeal was to "reduce the State's exposure to future losses under lawsuits that will be challenging in-state bond exemptions." Municipal Bond Taxation Hrg. on H.F. 1380 Before the Sales and Income Tax Division of the Committee on Taxes, 1995 Leg., 79th Sess. 6 (Mn. 1995) (statement of Rep. Ann Rest, Member, House Comm. on Taxes).[10] The Minnesota Commissioner of Finance also cautioned the legislature: "[T]his is a continuing tax code issue that will be with us whether it surfaces [now or in the future] . . . it is poor planning on our part to not recognize that a similar liability potential [tax refunds] is out there

[10] Tapes of committee meetings are available from the Minnesota Historical Society Library. Respondents will provide the cited tapes to the Court upon request.

on this issue." *Id.* (statement of Laura King, Comm'r of Finance, House Comm. on Taxes).[11]

More importantly, given the obviously discriminatory nature of its tax scheme and its obvious impact on interstate commerce, Kentucky's reliance argument rings hollow, as did Florida's argument in *McKesson* that its "reliance on a presumptively valid statute" was a "relevant consideration" in determining whether an "obligation to provide relief for its unconstitutional deprivation of property" exists. 496 U.S. at 46 (internal quotation omitted). The *McKesson* Court concluded that Florida could "hardly claim surprise" at the state court's invalidation of its taxation scheme, as the Court had invalidated a "virtually identical" scheme in *Bacchus*. *Id.*

I. Alternatively, Kentucky's Taxation Scheme Violates The Import-Export Clause.

Article I, § 10, cl. 2, of the Constitution provides that "[n]o State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws." Kentucky's discriminatory tax scheme violates this prohibition. The historical record shows that the Import-Export Clause extends to articles traded in commerce among the States as well as to those shipped to and from foreign nations. *Camps*, 520 U.S. at 609-40 (Thomas, J., dissenting); *Almy v. California*, 65 U.S. (24 How.) 169, 175 (1860) (overturning under Import-Export Clause a stamp tax on bills of

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[11] Utah has also considered the problem. When the legislature enacted its discriminatory tax scheme, the Office of Legislative Review and General Counsel observed that the "differential taxation of interest on debts might be challenged as discriminatory under the Commerce Clause of the Constitution of the United States." RSA 29a; *see* Leg. Rev. Note attached to H.B. 1006, 2001 Leg., 1st Spec. Sess. (Ut. 2001), *available at* http://www.le.state.ut.us/~2001S1/ bills/hbillamd/HB1006.pdf.

lading for gold shipped from California to New York). This interpretation is supported by THE FEDERALIST, which viewed as an unconstitutional evil not only tariffs that a State might impose on foreign trade, but duties that a State might impose on goods shipped through one State from other States. THE FEDERALIST NO. 42, at 235-36 (J. Madison) ("A very material object of this power was the relief of the States which import and export through other states from the improper contributions levied on them by the latter."). It is also supported by the fact that the clause creates an exception for inspection laws, which would have applied to goods shipped from one State to another as well as to goods shipped abroad.

The Import-Export Clause is one of four interrelated clauses that collectively and explicitly create a national trade zone free of domestic duties imposed by any State, and free of several types of duties that Congress might impose that could discriminate against the commercial interests of one State over another. Article I, § 8, cl. 1 gives Congress the power to lay uniform taxes, duties, imposts, and excises nationwide, but requires that they be "uniform." In turn, the Import-Export Clause explicitly removes from the States the authority to levy duties on imports and exports (except as necessary for inspection purposes). Article I, § 9, cl. 5 removes from Congress the authority to levy duties on exports abroad from any State, but leaves untouched Congress's power to tax imports from abroad. Finally, Article I, § 9, cl. 6 explicitly forbids Congress from levying duties that favor the ports of one State over those of another, and also mandates that ships going to and from domestic ports shall not be obliged to pay duties in these ports: "nor shall Vessels bound to, or from, one State, be obliged to enter, clear, or pay Duties in another." As used in the Import-Export Clause, the terms "import" and "export" refer to articles traded in interstate commerce, not just those traded abroad. Although the

term "impost" (also used in the clause) likely refers to a duty assessed shipside on goods imported from abroad, *see Camps*, 520 U.S. at 637-38 (Thomas, J., dissenting), the phrase "duties on imports or exports" did not bear such a limited connotation but would commonly have been understood to apply to taxes levied on goods or written instruments shipped in interstate commerce. *Id.* at 638-39. This interpretation makes particular sense because, if "duties on imports" meant only duties on *foreign* items, the reference to "imposts" would be redundant.

For these reasons, and as explained more thoroughly by Justice Thomas in his dissent in *Camps*, the determination of *Woodruff v. Parham*, 75 U.S. (8 Wall.) 123 (1868), that the Import-Export Clause applies only to foreign commerce is unsound, and the clause prohibits Kentucky from levying a duty on out-of-state municipal bonds. This does not prevent Kentucky from taxing the income its residents earn from municipal bonds but simply prohibits Kentucky from discriminating against out-of-state bonds through its tax scheme. That the scheme discriminates by exempting Kentucky's municipal bonds from taxation while taxing out-of-state municipal bonds, rather than by a direct duty or tariff, is of no moment. *West Lynn*, 512 U.S. at 210-11 (Scalia, J., concurring) (tax exemption only for in-state commodity is no different from discriminatory tax imposed only and directly on out-of-state commodity). Kentucky's tax scheme is a discriminatory duty proscribed by the Import-Export Clause and the Court should affirm the decision below on this alternative basis.

CONCLUSION

For the foregoing reasons, the Court should affirm the decision of the Kentucky Court of Appeals in this case.

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IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF
THE COMMONWEALTH OF KENTUCKY, et al.,

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,

Respondents.

ON WRIT OF CERTIORARI TO THE KENTUCKY COURT OF APPEALS

RESPONDENTS' SUPPLEMENTAL APPENDIX

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STATE LAWS GOVERNING TAXATION OF IN-STATE BONDS AND OUT-OF STATE BONDS		
STATES THAT IMPOSE TAX ON INTEREST EARNED ON OUT-OF-STATE BONDS WHILE EXEMPTING FROM TAX INTEREST EARNED ON ALL IN-STATE BONDS		
STATE	OUT OF STATE BOND TREATMENT	IN STATE BOND TREATMENT
Alabama	"Interest or other income on obligations of the United States, or its possessions, or interest or other income on bonds or other securities . . . received by any resident individual or by any corporation . . . shall be included in the gross income of such person or corporation in determining liability for income taxes due by such person or corporation." ALA. CODE § 40-18-4 (2003).	"Gross income does not include the following items which shall be exempt from income tax . . . Interest on obligations of the State of Alabama and any county, municipality, or other political subdivision thereof." ALA. CODE § 40-18-14(3)(f) (2003).
Arizona	"In computing Arizona adjusted gross income, the following amounts shall be added to Arizona gross income: . . . The amount of interest income received on obligations of any state, territory or possession of the United States, or any political subdivision thereof, located outside the state of Arizona, reduced, for tax years beginning from and after December 31, 1996, by the amount of any interest on indebtedness and other elated expenses that were incurred or continued to purchase or carry those obligations and that are not otherwise deducted or subtracted in arriving at Arizona gross income." ARIZ. REV. STAT. ANN. § 43-1021.3 (Supp. 2006).	
Arkansas	" 'Gross income' includes . . . Gains, profits, and income derived from interest, rent, royalties, dividends, annuities, securities, or the transaction of any business carried on for gain or profit" ARK. CODE ANN. § 26-51-404(a)(1)(D) (West 2007).	" 'Gross income' does not include the following items, which shall be exempt from taxation under this act: . . . Interest upon obligations of the United States or its possessions or upon obligations of the State of Arkansas or any political subdivision of the State of Arkansas" ARK. CODE ANN. § 26-51-404(b)(5) (1997).
California	Income which this state is prohibited from taxing includes interest on bonds issued by this state or a local government in this state, and the determination of whether a bond is issued by this state or a local government in this state shall be made without regard to (a) the source of payment of that bond or the security for that bond, public or private, and (b) whether or not public improvements are financed. If there is at any time following the original issuance of such a bond a separation in ownership between the bond and any	

	right to receive interest on the bond (whether or not evidenced by a coupon), payments or accruals on that stripped bond and stripped coupon shall be treated in a manner consistent with Section 1286(d) of the Internal Revenue Code. CAL. REV. & TAX. CODE § 17133 (West 2004).
Colorado	"There shall be added to the federal taxable income: . . . an amount equal to the interest income which is excluded from gross income for federal income tax purposes . . . less amortization of premium on obligations of any state or any political subdivision thereof, other than interest income on obligations of the state of Colorado or any political subdivision thereof . . . to the extent that such interest is specifically exempt from income taxation under the laws of the state of Colorado authorizing the issuance of such obligations." COLO. REV. STAT. § 39-22-104(3)(b) (2006).
Connecticut	"There shall be added thereto (i) to the extent not properly includable in gross income for federal income tax purposes, any interest income from obligations issued by or on behalf of any state, political subdivision thereof, or public instrumentality, state or local authority, district or similar public entity, exclusive of such income from obligations issued by or on behalf of the state of Connecticut, any political subdivision thereof, or public instrumentality, state or local authority, district or similar public entity created under the laws of the state of Connecticut and exclusive of any such income with respect to which taxation by any state is prohibited by federal law . . . (B) There shall be subtracted therefrom (vii) to the extent properly includable in determining the net gain or loss from the sale or other disposition of capital assets for federal income tax purposes, any gain from the sale or exchange of obligations issued by or on behalf of the state of Connecticut, any political subdivision thereof, or public instrumentality, state or local authority, district or similar public entity created under the laws of the state of Connecticut, in the income year such gain was recognized. . ." CONN. GEN. STAT. ANN. § 12-701(a)(20)(A)(i), (B)(vii) (West Supp. 2007).
Delaware	"There shall be added to federal adjusted gross income: (1) a. Interest qualifying under § 103 of the United States Internal Revenue Code of 1986 or any similar statute, other than interest on obligations and securities of this State and its political subdivisions and authorities; and b. Dividends paid by a regulated investment company (sometimes referred to as a mutual fund) qualifying under § 852(b)(5) of the United States Internal Revenue Code of 1986 or any similar statute; provided, that dividends attributable to interest on obligations and securities of this State and its political subdivisions and authorities may be excluded from such addition if the amount of interest attributable thereto is reported in writing to the holder or owner of the shares or units of the regulated investment company by or on behalf of the manager of the regulated investment company, and such report states the dollar amount or percentage of Delaware and non-Delaware dividends pertaining to the taxpayer." DEL. CODE ANN. tit. 30. 11, § 1106(a)(1) (1997). All bonds of the City of Wilmington are exempt from taxation under any law of this State. DEL. CODE ANN. tit. 30. 11, § 103 (2007).

District of Columbia	"Interest upon the obligations of a state, territory of the United States or any political subdivision thereof, but not including the District of Columbia, shall be included in the computation of District gross income; except, that individuals, estates and trusts shall not include interest on the obligations of the District of Columbia, a state, a territory of the United States, or any political subdivision thereof, in the computation of District gross income." D.C. CODE § 47-1083.02(a)(1) (2007).	
Georgia	"There shall be added to the taxable income: . . . Dividend or interest income, to the extent that the dividend or interest income is not included in gross income for federal income tax purposes, on obligations of any state except this state or of political subdivisions except political subdivisions of this state" GA. CODE. ANN. § 48-7-27(b)(1)(A) (2005).	
Idaho	"Add interest and dividends received or accrued during the taxable year from foreign securities and from securities issued by states and other political subdivisions exempt from federal income tax under the Internal Revenue Code, less applicable amortization." IDAHO CODE ANN. § 63-3022M(1) (2007).	"Subtract interest and dividends received or accrued during the taxable year from securities issued: . . . By the state of Idaho, its cities and political subdivisions, exempt from federal income tax under the Internal Revenue Code." IDAHO CODE ANN. § 63-3022M(3)(b) (2007).
Kansas	"There shall be added to federal adjusted gross income: Interest income less any related expenses directly incurred in the purchase of state or political subdivision obligations, to the extent that the same is not included in federal adjusted gross income, on obligations of any state or political subdivision thereof, but to the extent that interest income on obligations of this state or a political subdivision thereof issued prior to January 1, 1988, is specifically exempt from income tax under the laws of this state authorizing the issuance of such obligations, it shall be excluded from computation of Kansas adjusted gross income whether or not included in federal adjusted gross income. Interest income on obligations of this state or a political subdivision thereof issued after December 31, 1987, shall be excluded from computation of Kansas adjusted gross income whether or not included in federal adjusted gross income." KAN. STAT. ANN. §79-32,117(b)(1) (2007) (updated by 2007 KAN. Laws Ch. 195, relevant section not affected).	
Kentucky	"Include interest income derived from obligations of sister states and political subdivisions thereof" KY. REV. STAT. ANN. § 141.010(10)(c) (West Supp. 2006).	
Louisiana	"Tax Table Income", for resident individuals, means adjusted gross income plus interest on obligations of a state or political subdivision thereof, other than Louisiana and its municipalities, title to which obligations vested with the resident	"The amount of interest received upon obligations of the State of Louisiana, or any political or municipal subdivision thereof, to such extent as is now exempt by law shall not be included in gross income."

	individual on or subsequent to January 1, 1980. . ." allowable. (b) Interest on obligations of the state of Louisiana, its political subdivisions, public corporations created by them and constituted authorities thereof authorized to issue obligations on their behalf, title to which obligations vested with a resident individual shall be excluded from "tax table income" and is hereby declared exempt from state income taxation. LA. REV. STAT. ANN. § 47:293(6)(a), (b) (Supp. 2007).	Income" LA. REV. STAT. ANN. § 47:48 (2001).
Maine	"Federal adjusted gross income shall be increased by: . . . Interest or dividends on obligations or securities of any state other than this State, or of a political subdivision or authority of any state other than this State, to the extent that interest or those dividends are not included in the recipient's federal adjusted gross income." ME. REV. STAT. ANN. tit. 36. 805, § 5122(1)(A) (2007).	
Maryland	"To the extent excluded from federal adjusted gross income, the amounts under this section are added to the federal adjusted gross income of a resident to determine Maryland adjusted gross income. . . Dividends and interest from another state or local obligations. The addition under subsection (a) of this section includes interest or dividends, less related expenses, attributable to an obligation or security of: (1) another state; or (2) a political subdivision or authority of another state." MD. CODE ANN. TAX-GEN. §§ 10-204(b) (West 2007).	"In this section, 'tax preference items' mean the items that: . . . are further modified by excluding: . . . interest described in § 57(a)(5) of the Internal Revenue Code, if the interest is attributable to obligations of: 1. the State of Maryland; 2. a political subdivision or authority of the State; or 3. any other entity authorized under Maryland law to issue obligations the interest on which is excluded from gross income under § 103 of the Internal Revenue Code." MD. CODE ANN. § 10-222(a)(4)(ii) (West 2007).
Massachusetts	" Massachusetts gross income shall mean the federal gross income, modified as required by section six F, with the following further modifications:--(1) The items to be added thereto are:--(A) Interest on governmental obligations excluded under section one hundred and three of the Code, other than interest from any such obligation issued by the commonwealth, any political subdivision thereof, or any agency or instrumentality of either of the foregoing, which is exempt from taxation under any provision of law. MASS. GEN. LAWS ANN. CH. 62, § 2(a)(1)(A) (West Supp. 2007).	

Michigan	"Add gross interest income and dividends derived from obligations or securities of states other than Michigan, in the same amount that has been excluded from adjusted gross income less related expenses not deducted in computing adjusted gross income because of section 265(a)(1) of the internal revenue code." MICH. COMP. LAWS. ANN. § 206.30(1)(a) (West 2007).	
Minnesota	"For individuals, estates, and trusts, there shall be added to federal taxable income: interest income on obligations of any state other than Minnesota or a political or governmental subdivision, municipality, or governmental agency or instrumentality of any state other than Minnesota exempt from federal income taxes under the Internal Revenue Code or any other federal statute; and exempt-interest." MINN. STAT. ANN. § 290.01(19a)(1)(I)(i)(ii) (West 2007).	
Missouri	"There shall be added to the taxpayer's federal adjusted gross income: . . . Interest on certain governmental obligations excluded from federal gross income by Section 103 of the Internal Revenue Code. The previous sentence shall not apply to interest on obligations of the State of Missouri or any of its political subdivisions or authorities and shall not apply to interest described in subdivision (a) of subsection 3 of this section. The amount added pursuant to this paragraph shall be reduced by the amounts applicable to such interest that would have been deductible in computing the taxable income of the taxpayer except only for the application of Section 265 of the Internal Revenue Code." MO. ANN. STAT. § 143.121(2)(b) (West 2007).	
Montana	"Adjusted gross income is the taxpayer's federal adjusted income as defined in section 62 of the Internal Revenue Cod, 26 U.S.C. 62, and in addition includes the following: Interest received on obligations of another state or territory or county, municipality, district, or other political subdivision of another state, except to the extent that the interest is exempt from taxation by Montana under federal law." MONT. CODE ANN. § 15-13-111(1)(a)(i) (2005).	"Notwithstanding the provisions of the Internal Revenue Code, adjusted gross income does not include the following, which are exempt from taxation under this chapter: all interest income from obligations of the United States government, the state of Montana, or a county, municipality, district, or other political subdivision of the state and any other interest income that is exempt from taxation by Montana under federal law." MONT. CODE ANN. § 15-13-111(2)(a)(i) (2005).
Nebraska	"The following adjustments to federal adjusted gross income or, for corporations and fiduciaries, federal taxable income shall be made for interest or dividends received: . . . There shall be added interest or dividends received by the owner of obligations of the District of Columbia, other states of the United States, or their political subdivisions, authorities, commissions, or instrumentalities to the extent excluded in the computation of gross income for federal income tax purposes except that such interest or dividends shall not be added if received by a corporation which is a regulated investment company" Nebraska Legislative Bill 338 of 2007 First Regular Session updating NEB. REV. STAT. § 77-2716(1)(a) (2007).	

New Hampshire	"Income of the following described class is taxable: Interest from bonds, notes, money at interest, and from all debts due the person to be taxed except interest from notes or bonds of this state and notes or bonds of any political subdivision of this state." N.H. REV. STAT. ANN. § 77:4(I) (Supp. 2006).	
New Jersey	"Gross income shall not include interest on obligations (1) issued by or on behalf of this State or any county, municipality, school or other district, agency, authority, commission, instrumentality, public corporation (including one created or existing pursuant to agreement or compact with this or any other state), body corporate and politic or political subdivision of this State, or (2) those obligations which are statutorily free from State or local taxation under any other act of this State or under the laws of the United States." N.J. STAT. ANN. § 54:8A-6-14(West 2002).	
New Mexico	"Base income also includes interest received on a state or local bond." N.M STAT. ANN. § 7-2-2(B)(3) (2005).	"'State or local bond' means a bond issued by a state other than New Mexico's political subdivisions, the interest from which is excluded from income for federal income tax purposes under Section 103 of the Internal Revenue code, as that section may be amended or renumbered." N.M STAT. ANN. § 7-2-2(V) (2005).
New York	"There shall be added to federal adjusted gross income: Interest income on obligations of any state other than this state, or of a political subdivision of any such other state unless created by compact or agreement to which this state is a party, to the extent not properly includible in federal adjusted gross income" N.Y. LAW § 612(b)(1) (McKinney Supp. 2006).	
North Carolina	"The following additions to taxable income shall be made in calculating North Carolina taxable income, to the extent each item is not included in taxable income: Interest upon the obligations of states other than this State, political subdivisions of those states, and agencies of those states and their political subdivisions." N.C. GEN. STAT. ANN. § 105-134.6(c)(1) (2007).	"The following deductions from taxable income shall be made in calculating North Carolina taxable income, to the extent each item is included in taxable income: Interest upon the obligations of any of the following: . . . This State, a political subdivision of this State, or a commission, an authority, or another agency of this State or of a political subdivision of this State." N.C. GEN. STAT. ANN. § 105-134.6(b)(1)(b) (2007).
North Dakota	"The taxable income of an individual, estate, or trust as computed pursuant to the provisions of the United States Internal Revenue Code of 1954, as amended, shall be: . . . Increased by the amount of any interest and dividends from foreign securities and from securities of state and their political subdivisions exempt from federal income tax; provided, that interest upon obligations of the state of North Dakota or any of its political subdivisions shall not be included." N.D. CENT. CODE § 57-38-01.2(1)(g) (2005).	

Ohio	"'Adjusted gross income' or 'Ohio adjusted gross income' means federal adjusted gross income, as defined and used in the Internal Revenue Code, adjusted as provided in this section: Add interest or dividends on obligations or securities of any state or of any political subdivision or authority of any state, other than this state and its subdivisions and authorities." OHIO REV. CODE ANN. § 5747.01(A)(1) (2007).	
Oregon	"There shall be added to federal taxable income: Interest or dividends, exempt from federal income tax, on obligations or securities of any foreign state or of a political subdivision or authority of any foreign state. However, the amount added under this paragraph shall be reduced by any interest on indebtedness incurred to carry the obligations or securities described in this paragraph and by any expenses incurred in the production of interest or dividend income described in this paragraph." OR. REV. STAT. § 316.680(2)(a) (2005).	
Pennsylvania	"Every resident individual, estate or trust shall be subject to, and shall pay for the privilege of receiving each of the classes of income hereinafter enumerated in section 303, a tax upon each dollar of income received by that resident during that resident's taxable year at the rate of three and seven hundredths per cent. 72 PA. STAT. ANN. § 7302 (West Supp. 2007). "The classes of income referred to above are as follows: (6) Interest derived from obligations which are not statutorily free from State or local taxation under any other act of the General Assembly of the Commonwealth of Pennsylvania or under the laws of the United States, any amount paid under contract of life insurance or endowment or annuity contract which is includable in gross income for Federal income tax purposes and any amount paid out of the Archer Medical Savings Account (Archer MSA) or health savings account that is includable in the gross income of an account beneficiary for Federal income tax purposes." 72 PA. STAT. ANN. § 7303(a)(6) (West Supp. 2007).	"Except as provided in subsections (b) and (c), all obligations, interest on obligations and income from obligations issued on or after the effective date of this section by the Commonwealth, any public authority, commission, board or other agency created by the Commonwealth or any political subdivision of the Commonwealth or any public authority created by any political subdivision of the Commonwealth shall at all times be free from taxation for State and local purposes within the Commonwealth." 72 PA. STAT. ANN. § 9901(a) (West. Supp. 2007).

Rhode Island	" The Rhode Island income of a resident individual means his or her adjusted gross income for federal income tax purposes, with the modifications specified in this section...There shall be added to federal adjusted gross income: Interest income on obligations of any state, or its political subdivisions, other than Rhode Island or its political subdivisions." R.I. GEN. LAWS 1956, § 44-30-12(a), (b)(1) (Supp. 2006).	
South Carolina	"The exclusion from gross income authorized by Internal Revenue Code Section 103 (Interest on State and Local Bonds) is modified to exempt only interest on obligations of this State or any of its political subdivisions, and to exempt interest upon obligations of the United States. This modification applies to all Internal Revenue Code Sections referencing Section 103." S.C. CODE ANN. § 12-6-1120(1) (2000 & Supp. 2006).	
Tennessee	"An income tax in the amount of six percent (6%) per annum shall be levied and collected on incomes derived by way of dividends from stocks or by way of interest on bonds of each person, partnership, association, trust and corporation in the state of Tennessee who received, or to whom accrued, or to whom was credited during any year income from the sources enumerated in this section, except as otherwise provided in this chapter." TENN. CODE ANN. § 67-2-102 (e)(1) (Supp. 2006).	"Nothing contained in this chapter shall be construed or held to authorize the levy of an income tax on obligations of the United States, whether evidenced by bonds or otherwise and/or on shares of stock in corporations that are arms and agencies directly of the United States, insofar as such bonds and stocks are exempt from such taxation by the constitution or laws of the United States; or on the income derived from bonds of the State of Tennessee, or any county or municipality or other political subdivision of the state of Tennessee not subject to ad valorem taxation." TENN. CODE ANN. § 67-2-104(e)(1) (Supp. 2006).
Vermont	" 'Vermont net income' means, for any taxable year and for any corporate taxpayer: . . . (i) increased by: . . . (II) to the extent such income is exempted from taxation under the laws of the United States by the amount received by the tax payer on and after January 1, 1986 as interest income from state and local obligations, other than obligations of Vermont and its political subdivisions, and any dividends or other distributions from any fund to the extent such dividend or distribution is attributable to such Vermont state or local obligations." 32 VT. STAT. ANN. tit. 32, § 5811(18)(A)(i)(II) (2007).	
Virginia	"To the extent excluded from federal adjusted gross income, there shall be added:1. Interest, less related expenses to the extent not deducted in determining federal income, on obligations of any state other than Virginia, or of a political subdivision of any such other state unless created	"To the extent included in federal adjusted gross income, there shall be subtracted: . . . 2. Income derived from obligations, or on the sale or exchange of obligations of this Commonwealth or of any political subdivision or instrumentality of the Commonwealth." Chapter 359 of the

	by compact or agreement to which Virginia is a party" VA. CODE ANN. § 58.1 - 322(B)(1) (Supp. 2007).	2007 Session amending and reenacting VA. CODE ANN. § 58.1 - 322(C)(2) (Supp. 2007).
West Virginia	"There shall be added to federal adjusted gross income unless already included therein the following items: Interest obligations of any state other than this state or of a political subdivision of any other state unless created by compact or agreement to which this state is a party" W. VA. CODE ANN. § 11-21-12 (b)(1) (2007).	"There shall be subtracted from federal adjusted gross income to the extent included therein: . . . (2) Interest or dividend income on obligations or securities of any authority, commission or instrumentality of the United States or of the State of West Virginia to the extent includable in gross income for federal income tax purposes but exempt from state income taxes under the laws of the United States or of the State of West Virginia, including federal interest or dividends paid to shareholders of a regulated investment company, under Section 852 of the Internal Revenue Code for taxable years ending after the thirtieth day of June, one thousand nine hundred eighty-seven." W. VA. CODE ANN. § 11-21-12 (c)(2) (2007).

STATES THAT IMPOSE TAX ON INTEREST EARNED ON OUT-OF-STATE BONDS WHILE EXEMPTING FROM TAX INTEREST EARNED ONLY ON SOME IN-STATE BONDS		
STATE	OUT OF STATE BOND TREATMENT	IN-STATE BOND TREATMENT
Hawaii	"(b) There shall be included in gross income, adjusted gross income, and taxable income: . . . (2) unless expressly exempted or excluded as provided by subsection (a)(6), interest on the obligations of a State or a political subdivision thereof." HAW. REV. STAT. ANN. § 235-7 (2007).	The following excerpt is in place for County and State General Obligation Bonds, and County and State Revenue Bonds with only the name of the type of bond changed: " . . . bonds issued under this chapter, to the extent practicable, shall be issued so as to comply with requirements imposed by valid federal law providing that the interest on the bonds shall be excluded from gross income for federal income [tax] purposes (except as certain minimum taxes or environmental taxes may apply). The director of finance is authorized to enter into such agreements, establish such funds or accounts and take any action as required in order to comply with such valid federal law. Nothing in this chapter shall be deemed to prohibit the issuance of revenue bonds, the interest on which may be included in gross income for federal income tax purposes. For the purpose of ensuring that interest on revenue bonds issued pursuant to this chapter which is excluded from gross income for federal income tax purposes (except as provided above) on the date of issuance shall continue to be so excluded, no county officer or employee or user of an undertaking or loan program shall authorize or allow any change, amendment, or modification to an undertaking or loan program financed or refinanced with the proceeds of revenue bonds which change, amendment or modification would affect the exclusion of interest on the revenue bonds from gross income for

		federal income tax purposes unless the change, amendment, or modification shall have received the prior approval of the director of finance. Failure to receive the approval of the director of finance shall render any change, amendment, or modification void. HAW. REV. STAT. ANN. § 49-15 (2007). "To the extent practicable, special purpose revenue bonds issued pursuant to this part shall be issued to comply with requirements imposed by applicable federal law providing that the interest on the special purpose revenue bonds shall be excluded from gross income for federal income tax purposes, except as certain minimum taxes or environmental taxes may apply. The director of finance may enter into agreements, establish funds or accounts, and take any action required to comply with applicable federal law. Nothing in this part shall be deemed to prohibit the issuance of special purpose revenue bonds, the interest on which may be included in gross income for federal income tax purposes. HAW. REV. STAT. ANN. § 39A-325 (2007).
Illinois	"In the case of an individual, base income means an amount equal to the taxpayer's adjusted gross income for the taxable year as modified by paragraph 2. The adjusted gross income . . . shall be modified by adding thereto to sum of the following amounts . . . An amount equal to all amounts paid or accrued to the taxpayer as interest or dividends during the taxable year to the extent excluded from gross income in the computation of	Obligations from the following Illinois institutions are exempt from income tax: Illinois Housing Development Authority Does not include housing-related commercial facilities notes and bonds. Export Development Act of 1983

	adjusted gross income, except stock dividends of qualified public utilities described in Section 305(e) of the Internal Revenue Code" 35 ILL. COMP. STAT ANN. 5/203 (West 2007).	Illinois Development Finance Authority Act Includes only bonds and notes issued pursuant to Sections 7.50 - 7.61, specifically, venture fund and infrastructure bonds. Quad Cities Regional Economic Development Authority Includes only bonds and notes that the Authority has declared to be exempt. College Savings Bonds Includes only bonds and notes issued under the General Obligation Bond Act in accordance with the Baccalaureate Savings Act. Illinois Sports Facilities Authority Higher Education Student Assistance Act Includes only bonds and notes issued on or after September 2, 1988. Illinois Development Finance Authority Includes only bonds and notes issued in accordance with the Asbestos Abatement Finance Act. Rural Bond Bank Act Illinois Development Finance Authority Act Includes only bonds and notes issued pursuant to Sections 7.80 - 7.87. Quad Cities Interstate Metropolitan Authority Includes only bonds and notes issued under the Quad Cities Interstate Metropolitan Authority Act. Southwestern Illinois Development Authority

		Includes only bonds and notes issued pursuant to the Southwestern Illinois Development Authority Act. Illinois Finance Authority Includes only bonds and notes issued under the Illinois Finance Authority Act and the Asbestos Abatement Finance Act. Brian Hamer, INCOME EXEMPT FROM TAXATION, 101 Illinois Department of Revenue Publication 1, 4-5 (December 2006).
Iowa	"The term "net income" means the adjusted gross income before the net operating loss deduction as properly computed for federal income tax purposes under the Internal Revenue Code, with the following adjustments: 2. Add interest and dividends from foreign securities of stat and other political subdivisions exempt from federal income tax under the Internal Revenue Code." IOWA CODE ANN. § 422.7(2) (West 2007).	"The term "net income" means the adjusted gross income before the net operating loss deduction as properly computed for federal income tax purposes under the Internal Revenue Code, with the following adjustments: 36. Add, to the extent not already included, income from the sale of obligations of the state and its political subdivisions. Income from the sale of these obligations is exempt from the taxes imposed by this division only if the law authorizing these obligations specifically exempts the income from the sale from the state individual income tax." IOWA CODE ANN. § 422.7(36) (West 2007).
Mississippi	"For the purposes of this article, except as otherwise provided, the term "gross income" means and includes the income of a taxpayer derived from salaries, wages, fees or compensation for service, of whatever kind and in whatever form paid, including income from governmental agencies and subdivisions thereof; or from professions, vocations, trades, businesses, commerce or sales, or renting or dealing in property, or reacquired property; also from annuities, interest, rents, dividends,	"The words 'gross income' do not include the following items of income which shall be exempt from taxation under this article: . . . Interest upon the obligations of the United States or its possessions, or securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916, or bonds issued by the War Finance Corporation, or obligations of the State of Mississippi or political subdivisions thereof." MISS. CODE ANN. § 27-7-15(4)(d) (West 2007).

	securities, insurance premiums, reinsurance premiums, considerations for supplemental insurance contracts, or the transaction of any business carried on for gain or profit, or gains, or profits, and income derived from any source whatever and in whatever form paid. The amount of all such items of income shall be included in the gross income for the taxable year in which received by the taxpayer. The amount by which an eligible employee's salary is reduced pursuant to a salary reduction agreement authorized under Section 25-17-5 shall be excluded from the term "gross income" within the meaning of this article." MISS. CODE ANN. § 27-7-15(1) (West 2007).	
Oklahoma	"The taxable income of any taxpayer shall be adjusted to arrive at Oklahoma taxable income for corporations and Oklahoma adjusted gross income for individuals, as follows: 1. There shall be added interest income on obligations of any state or political subdivision thereto which is not otherwise exempted pursuant to other laws of this state, to the extent that such interest is not included in taxable income and adjusted gross income." OKLA. STAT. ANN. Revenue and Taxation,68 § 2358 (2007).	"All bonds, notes, debentures, evidences of indebtedness, lease purchase agreements, certificates of participation, commercial paper, or other obligations issued by the State of Oklahoma, the Oklahoma Capitol Improvement Authority, the Oklahoma Municipal Power Authority, the Oklahoma Student Loan Authority, and the Oklahoma Transportation Authority, the income therefrom, including, without limitation, any profit made on the sale thereof, and the transfer thereof, including, without limitation, estate or inheritance taxes, shall at all times be free from taxation within this state." OKLA. STAT. ANN. Revenue and Taxation, 68 § 2358.5A(A)(2007). "Interest on local governmental obligations issued after the effective date of this act for purpose other than to provide financing for projects for

		nonprofit corporations shall be exempt from Oklahoma income taxation. For these purposed local governmental obligations shall include bonds or notes issued by, or on behalf of, or for the benefit of Oklahoma educational institutions, cities, towns, or counties or by public trusts of which any of the foregoing is a beneficiary." OKLA. STAT. ANN. Revenue and Taxation, 68 § 2358.5(A) (2007). "Interest on governmental obligations issued by the Oklahoma Department of Transportation after the effective date of this act for purposes of highway construction and maintenance shall be exempt from Oklahoma income taxation." OKLA. STAT. ANN. Revenue and Taxation, 68 § 2358.5(B) (2007).
Wisconsin	"To federal adjusted gross income add: 1. The amount of any interest, except interest under par. (b)1, less related expenses, which is not included in federal adjusted gross income, and except the amount of any interest or original issue discount derived from bonds issued under subch. IV of ch. 18." WIS. STAT. ANN. § 71.05(6)(a)(1) (2007).	"There shall be exempt from taxation under this subchapter the following: . . . (c) Certain Interest income. Interest received on bonds or notes issued by any of the following: 1. The Wisconsin Housing and Economic Development Authority under s. 234.65, if the bonds are used to fund an economic development loan to finance construction, renovation, or development of property that would be exempt under s. 70.11(36). 1m. The Wisconsin Housing and Economic Development Authority under s. 234.08 or 234.61, on or after January 1, 2004, if the bonds or notes are issued to fund multifamily affordable housing projects or elderly housing projects. 3. A local exposition district created under subch. II of ch. 229. 4. A local professional baseball park district created under subch. III of ch. 229.

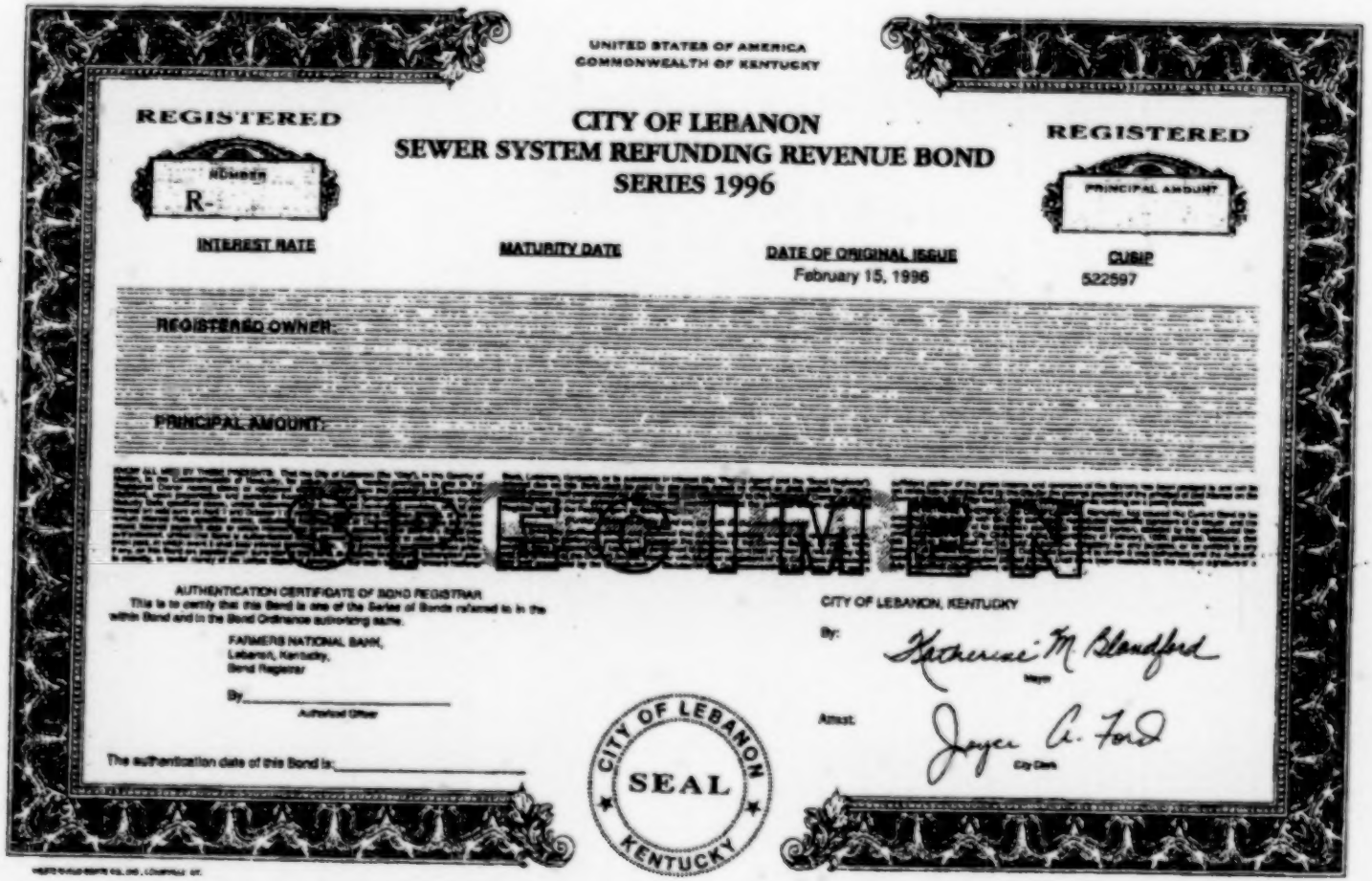
		5. A local professional football stadium district created under subch. IV of ch. 229. 6. A local cultural arts district created under subch. V of ch. 229. 7. The Wisconsin Aerospace Authority." WIS. STAT. ANN. § 71.05(1)(c) (2007).

UTAH EXEMPTS OUT OF STATE BONDS ONLY IF STATE IN QUESTION EXEMPTS UTAH BONDS.		
STATE	TAXATION OF OUT OF STATE BONDS	EXEMPTION OF OUT OF STATE BONDS
Utah	"There shall be added to federal taxable income of a resident or nonresident individual: . . . except as provided in Subsection (6), for taxable years beginning on or after January 1, 2003, for bonds, notes, and other evidences of indebtedness acquired on or after January 1, 2003, the interest from bonds, notes, and other evidences of indebtedness issued by one or more of the following entities: (i) a state other than this state; (ii) the District of Columbia; (iii) a political subdivision of a state other than this state; or (iv) an agency or instrumentality of an entity described in Subsections (1)(g)(i) through (iii). UTAH CODE ANN. § 59-10-114(1)(g) (2007).	" Notwithstanding Subsection (1)(g), interest from bonds, notes, and other evidences of indebtedness issued by an entity described in Subsections (1)(g)(i) through (iv) may not be added to federal taxable income of a resident or nonresident individual if, as annually determined by the commission: (a) for an entity described in Subsection (1)(g)(i) or (ii), the entity and all of the political subdivisions, agencies, or instrumentalities of the entity do not impose a tax based on income on any part of the bonds, notes, and other evidences of indebtedness of this state; or (b) for an entity described in Subsection (1)(g)(iii) or (iv), the following do not impose a tax based on income on any part of the bonds, notes, and other evidences of indebtedness of this state: (i) the entity; or (ii)(A) the state in which the entity is located; or (B) the District of Columbia, if the entity is located within the District of Columbia. UTAH CODE ANN. § 59-10-114(6) (2007).

STATES THAT IMPOSE NO INCOME TAX
Alaska
Florida
Nevada
South Dakota
Texas
Washington
Wyoming

ONLY NONDISCRIMINATORY TAX STATUTE
Indiana

BEST AVAILABLE COPY



UNITED STATES OF AMERICA
COMMONWEALTH OF KENTUCKY

REGISTERED

No.
R-

CITY OF LEBANON
SEWER SYSTEM REFUNDING REVENUE BOND
SERIES 1996

REGISTERED

PRINCIPAL AMOUNT

INTEREST RATE | MATURITY DATE | DATE OF ORIGINAL ISSUE | CUSIP

February 15, 1996 | 522597

REGISTERED OWNER:

PRINCIPAL AMOUNT:

SPECIMEN

AUTHENTICATION CERTIFICATE OF BOND REGISTRAR

This is to certify that this Bond is one of the Series of Bonds referred to in the within Bond and in the Bond Ordinance authorizing same.

FARMERS NATIONAL BANK,
Lebanon, Kentucky,
Bond Registrar

By: _____
Authorized Officer

The authentication date of this Bond is: _____

CITY OF LEBANON, KENTUCKY

By: Katherine M. Blandford
Mayor

Attest: Joyce A. Ford
City Clerk

CITY OF LEBANON
SEAL
KENTUCKY

RSA-18a

UNITED STATES OF AMERICA
STATE OF ALABAMA

REGISTERED

REGISTERED

CITY OF BIRMINGHAM
GENERAL OBLIGATION CAPITAL IMPROVEMENT BOND
Series 1990-A

INTEREST RATE

MATURITY DATE

CUSIP

Subject to prior payment and other provisions as herein provided

The CITY OF BIRMINGHAM, a municipal corporation in the State of Alabama (herein called the "City"), will pay to

SPECIMEN

or registered assigns, the principal sum of

DOLLARS

on the date specified above with interest thereon from the date hereof until the maturity hereof at the per annum rate of interest specified above (computed on the basis of a 360-day year of twelve consecutive 30-day months), payable on October 1, 1990, and semiannually on each April 1 and October 1 thereafter until and at the maturity hereof. The principal hereof as well as any premium hereon shall be payable in lawful money of the United States of America at the principal office of First Alabama Bank, Birmingham, Alabama, as paying agent (herein called the "Bank"), and the interest hereon shall be paid by check or draft mailed to the then registered holder hereof at the address of the said holder as it appears on the registry books of the Bank pertaining to the Bonds hereinafter referred to, notwithstanding the foregoing, the holder of any such Bond in a principal amount of not less than $100,000 may by written instructions delivered to the Bank request that payments of principal of or interest on such Bond be made by wire transfer in immediately available funds to a bank within the continental United States or by any similar method providing for payment in immediately available funds at the place of payment provided for herein, and such holder shall pay all of the expenses and charges related to the [illegible] by the City or the Bank to the person in whose name this bond is registered at the close of business on the fifteenth day of the month next preceding the interest payment date, whether or not such day is a business day, and shall cease to be payable to such person upon the transfer of ownership of this bond unless the City defaults in the payment of interest due on such interest payment date, in which event such interest shall be payable to the person in whose name this bond is registered at the close of business on the date fixed by the City for the payment of such defaulted interest. Any installment of this bond called for redemption and not paid when due shall continue to bear interest at the rate specified above until the principal hereof and the interest hereon shall be paid in full.

This bond is one of a duly authorized series of [illegible] aggregating $40,000,000 [illegible] dollars, which series constitutes one of seven separate series of bonds [illegible] Bonds").

REGISTERED

REGISTRATION CERTIFICATE

Date of Registration:

This bond was registered in the name of the above-registered owner on the registration date set forth above.

FIRST ALABAMA BANK,
as Paying Agent

By SPECIMEN
Its Authorized Officer

The Bonds are authorized to be issued pursuant to the applicable provisions of the constitution and laws of Alabama, including particularly Chapter 81 of Title 11 of the Code of Alabama 1975, as amended, a special municipal bond election held in the City on October 16, 1990, and an ordinance (herein called the "Bond Ordinance") duly adopted by the governing body of the City, for purposes for which the City is authorized by law to borrow money and to issue bonds.

REFERENCE IS MADE TO THE FURTHER PROVISIONS OF THIS BOND SET FORTH ON THE REVERSE HEREOF.

[illegible] to the validity hereof.

IN WITNESS WHEREOF, the City has caused this bond to be executed by the [illegible] with the facsimile signatures of its Mayor and its Director of Finance, a facsimile of its corporate seal to be affixed hereto, and has caused the said seal and signatures to be attested by a facsimile of the signature of the City Clerk, all [illegible] this bond to be dated April 1, 1990.

CITY OF BIRMINGHAM, ALABAMA

By: Richard Arrington, Jr.
Mayor

By: SPECIMEN
Director of Finance

Attest: SPECIMEN
City Clerk

Official Seal
Birmingham, Alabama

© SOUTHERN BANKNOTE CO. INC. - BIRMINGHAM, ALABAMA

RSA-19a

Book-Entry Only

Ratings: See "Ratings" herein

NEW ISSUE

In the opinion of Kutak Rock LLP, Bond Counsel, under existing laws, regulations, rulings and judicial decisions, interest on the Bonds (including original issue discount treated as interest) is excluded from gross income for federal income tax purposes and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations, except that such interest must be included in the "adjusted current earnings" of certain corporations for purposes of calculating alternative minimum taxable income. Bond Counsel also is of the opinion that, under existing laws of the Commonwealth of Kentucky, interest on the Bonds is excluded from the gross income of the recipients thereof for Kentucky income tax purposes and the Bonds are exempt from ad valorem taxes by the Commonwealth of Kentucky and all political subdivisions thereof. See "Tax Exemption" herein.

$145,290,000
COMMONWEALTH OF KENTUCKY
State Property and Buildings Commission
Revenue Bonds, Project No. 79

Dated: Date of delivery

Due: October 1, as shown below

The Revenue Bonds, Project No. 79 (the "Bonds") will be issued only as fully registered bonds, and when issued, will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"), which will act as securities depository for the Bonds. Purchasers will not receive certificates representing their ownership interest in the Bonds purchased. So long as DTC or its nominee is the registered owner of the Bonds, payments of the principal of and interest due on the Bonds will be made directly to DTC. The Bonds will be issued in denominations of $5,000 or any integral multiple thereof and will bear interest payable on each April 1 and October 1, commencing on April 1, 2004. Principal of, redemption premium, if any, and interest on the Bonds will be paid directly to DTC by J.P. Morgan Trust Company, National Association, Louisville, Kentucky as Trustee and Paying Agent.

Certain of the Bonds are subject to redemption prior to maturity at the times and in the amounts described herein.

The Bonds mature on the dates, in the principal amounts, bear interest at the rates per annum and have the prices or yields as follows:

Maturity	Principal Amount	Interest Rate	Price/ Yield	Maturity	Principal Amount	Interest Rate	Price/ Yield
October 1, 2016	$4,410,000	4.100%	100%	October 1, 2020	$220,000	4.450%	4.50%
October 1, 2016	11,865,000	5.125%	4.10%	October 1, 2020	20,325,000	5.000%	4.50%
October 1, 2017	1,335,000	4.200%	100%	October 1, 2021	200,000	4.550%	4.60%
October 1, 2017	16,320,000	5.125%	4.20%	October 1, 2021	21,395,000	5.000%	4.60%
October 1, 2018	2,085,000	4.250%	4.29%	October 1, 2022	2,045,000	4.625%	4.67%
October 1, 2018	16,480,000	5.125%	4.29%	October 1, 2022	20,655,000	5.000%	4.67%
October 1, 2019	550,000	4.375%	4.38%	October 1, 2023	8,425,000	4.750%	4.79%
October 1, 2019	18,980,000	5.125%	4.38%				

The Bonds are being issued by the State Property and Buildings Commission (the "Commission"), an independent agency of the Commonwealth of Kentucky (the "Commonwealth"), at the request of the Finance and Administration Cabinet of the Commonwealth (the "Cabinet") pursuant to a Resolution adopted August 18, 2003 to (i) pay costs of constructing, acquiring, installing and equipping the Project (as described and defined herein) and (ii) pay costs of issuing the Bonds.

The scheduled payment of principal of and interest on the Bonds, when due, will be guaranteed under an insurance policy to be issued concurrently with the delivery of the Bonds by MBIA Insurance Corporation.

MBIA

THE BONDS ARE SPECIAL AND LIMITED OBLIGATIONS OF THE COMMISSION. THE BONDS DO NOT CONSTITUTE A DEBT, LIABILITY, OR OBLIGATION OF THE COMMONWEALTH, OR A PLEDGE OF THE FULL FAITH AND CREDIT OR TAXING POWER OF THE COMMONWEALTH, BUT ARE PAYABLE SOLELY FROM AMOUNTS DEPOSITED IN CERTAIN FUNDS AND ACCOUNTS CREATED BY THE RESOLUTION AND FROM RENTAL INCOME DERIVED FROM A BIENNIALLY RENEWABLE LEASE AND CERTAIN SUBLEASES (EACH AS DESCRIBED AND DEFINED HEREIN), THE RENT FROM WHICH IS SUBJECT TO APPROPRIATION BY THE GENERAL ASSEMBLY OF THE COMMONWEALTH ON A BIENNIAL BASIS. THE BONDHOLDERS HAVE NO SECURITY INTEREST IN ANY PROPERTIES CONSTITUTING THE PROJECT OR ANY AMOUNTS DERIVED THEREFROM. See "SECURITY FOR THE BONDS" herein.

The Bonds are offered when, as and if issued and accepted by the Underwriters, subject to the approving legal opinion of Kutak Rock LLP, Omaha, Nebraska, Bond Counsel. Certain legal matters will be passed on for the Underwriters by their counsel, Peck, Shaffer & Williams LLP, Covington, Kentucky. It is expected that delivery of the Bonds will be made on or about October 9, 2003, in New York, New York, through the facilities of DTC, against payment therefor.

UBS Financial Services Inc.

Morgan Stanley — **Citigroup**

J.J.B. Hilliard, W.L. Lyons, Inc. — **Morgan Keegan & Company, Inc.** — **A.G. Edwards & Sons, Inc.**

Ross, Sinclaire & Associates, Inc. — **First Kentucky Securities Corporation** — **Banc One Capital Markets, Inc.**

Edward D. Jones & Co., L.P. — **Merrill Lynch & Co.** — **NatCity Investments, Inc.**

Dated: September 24, 2003

OFFICIAL STATEMENT DATED NOVEMBER 14, 2006

NEW ISSUE
BOOK ENTRY

RATINGS: **Moody's: Aaa**
Standard & Poor's: AAA
Fitch: AAA

In the opinion of Kennedy & Graven, Chartered, bond counsel, according to present federal and Minnesota laws, regulations, rulings, and decisions, interest on the Bonds is not includable in gross income for federal income tax purposes or in taxable net income of individuals, estates, and trusts for Minnesota income tax purposes. Interest on the Bonds is subject to Minnesota franchise taxes imposed on corporations and financial institutions. Interest on the Bonds is not an item of tax preference for purposes of the federal alternative minimum tax applicable to all taxpayers or the Minnesota alternative minimum tax applicable to individuals, estates, and trusts. Interest on the Bonds is includable in adjusted current earnings of corporations in determining alternative minimum taxable income for purposes of federal and Minnesota alternative minimum taxes. See "TAX EXEMPTION AND COLLATERAL TAX MATTERS" herein.

$35,000,000
STATE OF MINNESOTA
911 Revenue Bonds
(Public Safety Radio Communications System Project)
Series 2006

Dated: November 1, 2006 Due: June 1, as shown below

Year	Amount	Interest Rate	Price or Yield	CUSIP 60412L
2008	$ 2,590,000	4.00%	3.53%	AA7
2009	$ 2,690,000	5.00	3.58	AB5
2010	$ 2,795,000	5.00	3.58	AC3
2011	$ 2,905,000	4.00	3.58	AD1
2012	$ 3,025,000	4.25	3.59	AE9
2013	$ 3,150,000	5.00	3.61	AF6
2014	$ 3,280,000	5.00	3.65	AG4
2015	$ 3,415,000	5.00	3.70	AH2
2016	$ 3,560,000	5.00	3.74	AJ8
2017	$ 3,715,000	5.00	3.78	AK5
2018	$ 3,875,000	5.00	3.82	AL3

THE 911 REVENUE BONDS (PUBLIC SAFETY RADIO COMMUNICATIONS SYSTEM PROJECT), SERIES 2006 (THE "BONDS") ARE BEING ISSUED UNDER AND PURSUANT TO LAWS OF MINNESOTA 2005, CHAPTER 136, ARTICLE 1, SECTION 9, SUBDIVISION 8, AND MINNESOTA STATUTES, SECTION 403.275, AND AN ORDER OF THE COMMISSIONER OF FINANCE DATED NOVEMBER 1, 2006 (THE "ORDER"), AND ARE SPECIAL, LIMITED OBLIGATIONS OF THE STATE PAYABLE SOLELY FROM AND SECURED BY APPROPRIATIONS FROM THE 911 EMERGENCY TELECOMMUNICATIONS SERVICE ACCOUNT PURSUANT TO MINNESOTA STATUTES, SECTION 403.30. THE PLEDGED REVENUES ARE DERIVED FROM FEES IMPOSED BY THE STATE ON EACH CUSTOMER OF A TELEPHONE SERVICE PROVIDER THAT FURNISHES SERVICE CAPABLE OF ORIGINATING A 911 EMERGENCY TELEPHONE CALL. THE BONDS ARE NOT GENERAL OBLIGATIONS OF THE STATE, AND ARE NOT SECURED BY A PLEDGE OF THE FULL FAITH AND CREDIT AND TAXING POWERS OF THE STATE.

The Bonds maturing on June 1, 2017, and June 1, 2018, will be subject to redemption and prepayment at the option of the State on December 1, 2016, and any date thereafter at a price of par plus accrued interest.

Payment of the principal of and interest on the Bonds when due will be insured by a financial guaranty insurance policy to be issued by MBIA Insurance Corporation simultaneously with the delivery of the Bonds.

MBIA

The Bonds will be available to purchasers in book entry form only, and initially will be registered in the name of Cede & Co., nominee of The Depository Trust Company, New York, New York ("DTC"), which will act as securities depository for the Bonds. The Bank of New York Trust Company, N.A., in Dallas, Texas, will act as Bond Registrar and Paying Agent for the Bonds.

The Bonds are offered by the State subject to the legal opinions of Kennedy & Graven, Chartered, bond counsel, as to the validity of the Bonds and tax exemption. Delivery will be made on or about November 22, 2006. This cover page contains certain information for quick reference only. It is *not* a summary of this issue. Investors must read the entire Official Statement to obtain information essential to the making of an informed investment decision.

LEGISLATIVE GENERAL COUNSEL
₤ Approved for Filing: R.L. Rockwell ₤
₤ 06-20-01 9:20 AM ₤

H.B. 1006

INDIVIDUAL INCOME TAX - ADDITION OF INTEREST TO FEDERAL TAXABLE INCOME

2001 FIRST SPECIAL SESSION

STATE OF UTAH

Sponsor: Greg J. Curtis

This act modifies the Individual Income Tax Act to provide that for taxable years beginning on or after January 1, 2002, interest on certain bonds, notes, and other indebtedness of other states or the District of Columbia is subject to state individual income taxation. This act makes technical changes.

This act affects sections of Utah Code Annotated 1953 as follows:

AMENDS:

59-10-114, as last amended by Chapters 116 and 233, Laws of Utah 2001

Be it enacted by the Legislature of the state of Utah:

Section 1. Section **59-10-114** is amended to read:

59-10-114. Additions to and subtractions from federal taxable income of an individual.

(1) There shall be added to federal taxable income of a resident or nonresident individual:

(a) the amount of any income tax imposed by this or any predecessor Utah individual income tax law and the amount of any income tax imposed by the laws of another state, the District of Columbia, or a possession of the United States, to the extent deducted from federal adjusted gross income, as defined by Section 62, Internal Revenue Code, in determining federal taxable income;

(b) a lump sum distribution that the taxpayer does not include in adjusted gross income on the taxpayer's federal individual income tax return for the taxable year;

(c) for taxable years beginning on or after January 1, 2002, the amount of a child's income calculated under Subsection (5) that:

(i) a parent elects to report on the parent's federal individual income tax return for the

taxable year; and

(ii) the parent does not include in adjusted gross income on the parent's federal individual income tax return for the taxable year;

(d) 25% of the personal exemptions, as defined and calculated in the Internal Revenue Code;

(e) a withdrawal from a medical care savings account and any penalty imposed in the taxable year if:

(i) the taxpayer did not deduct or include the amounts on his federal tax return pursuant to Section 220, Internal Revenue Code; and

(ii) the withdrawal is subject to Subsections 31A-32a-105(1) and (2); [~~and~~]

(f) the amount refunded to a participant under Title 53B, Chapter 8a, Higher Education Savings Incentive Program, in the year in which the amount is refunded[~~.~~]; and

(g) except as provided in Subsection (6), for taxable years beginning on or after January 1, 2002, for bonds, notes, and other evidences of indebtedness acquired on or after January 1, 2002, the interest from bonds, notes, and other evidences of indebtedness issued by one or more of the following entities:

(i) a state other than this state;

(ii) the District of Columbia;

(iii) a political subdivision of a state other than this state; or

(iv) an agency or instrumentality of an entity described in Subsections (1)(g)(i) through (iii).

(2) There shall be subtracted from federal taxable income of a resident or nonresident individual:

(a) the interest or dividends on obligations or securities of the United States and its possessions or of any authority, commission, or instrumentality of the United States, to the extent includable in gross income for federal income tax purposes but exempt from state income taxes under the laws of the United States, but the amount subtracted under this Subsection (2)(a) shall be reduced by any interest on indebtedness incurred or continued to purchase or carry the obligations or securities described in this Subsection (2)(a), and by any expenses incurred in the production of interest or dividend income described in this Subsection (2)(a) to the extent that such expenses, including amortizable bond premiums, are deductible in determining federal taxable

income;

(b) 1/2 of the net amount of any income tax paid or payable to the United States after all allowable credits, as reported on the United States individual income tax return of the taxpayer for the same taxable year;

(c) the amount of adoption expenses which, for purposes of this Subsection (2)(c), means any actual medical and hospital expenses of the mother of the adopted child which are incident to the child's birth and any welfare agency, child placement service, legal, and other fees or costs relating to the adoption;

(d) amounts received by taxpayers under age 65 as retirement income which, for purposes of this section, means pensions and annuities, paid from an annuity contract purchased by an employer under a plan which meets the requirements of Section 404(a)(2), Internal Revenue Code, or purchased by an employee under a plan which meets the requirements of Section 408, Internal Revenue Code, or paid by the United States, a state, or political subdivision thereof, or the District of Columbia, to the employee involved or the surviving spouse;

(e) for each taxpayer age 65 or over before the close of the taxable year, a $7,500 personal retirement exemption;

(f) 75% of the amount of the personal exemption, as defined and calculated in the Internal Revenue Code, for each dependent child with a disability and adult with a disability who is claimed as a dependent on a taxpayer's return;

(g) any amount included in federal taxable income that was received pursuant to any federal law enacted in 1988 to provide reparation payments, as damages for human suffering, to United States citizens and resident aliens of Japanese ancestry who were interned during World War II;

(h) subject to the limitations of Subsection (3)(e), amounts a taxpayer pays during the taxable year for health care insurance, as defined in Title 31A, Chapter 1, General Provisions:

(i) for:

(A) the taxpayer;

(B) the taxpayer's spouse; and

(C) the taxpayer's dependents; and

(ii) to the extent the taxpayer does not deduct the amounts under Section 125, 162, or 213, Internal Revenue Code, in determining federal taxable income for the taxable year;

(i) (i) except as otherwise provided in this Subsection (2)(i), the amount of a contribution made [~~in~~] during the [~~tax~~] taxable year on behalf of the taxpayer to a medical care savings account and interest earned on a contribution to a medical care savings account established pursuant to Title 31A, Chapter 32a, Medical Care Savings Account Act, to the extent the contribution is accepted by the account administrator as provided in the Medical Care Savings Account Act, and if the taxpayer did not deduct or include amounts on [~~his~~] the taxpayer's federal individual income tax return pursuant to Section 220, Internal Revenue Code[~~.~~ ~~A~~]; and

(ii) contribution deductible under this Subsection (2)(i) may not exceed either of the following:

[~~(i)~~] (A) the maximum contribution allowed under the Medical Care Savings Account Act for the tax year multiplied by two for taxpayers who file a joint return, if neither spouse is covered by health care insurance as defined in Section 31A-1-301 or self-funded plan that covers the other spouse, and each spouse has a medical care savings account; or

[~~(ii)~~] (B) the maximum contribution allowed under the Medical Care Savings Account Act for the tax year for taxpayers:

[~~(A)~~] (I) who do not file a joint return; or

[~~(B)~~] (II) who file a joint return, but do not qualify under Subsection (2)(i)(i)(A); and

(j) the amount included in federal taxable income that was derived from money paid by the taxpayer to the program fund under Title 53B, Chapter 8a, Higher Education Savings Incentive Program, not to exceed amounts determined under Subsection 53B-8a-106(1)(d) and investment income earned on participation agreements under Subsection 53B-8a-106(1) when used for higher education costs of the beneficiary;

(k) for [~~tax~~] taxable years beginning on or after January 1, 2000, any amounts paid for premiums for long-term care insurance as defined in Section 31A-1-301 to the extent the amounts paid for long-term care insurance were not deducted under Section 213, Internal Revenue Code, in determining federal taxable income; and

(l) for taxable years beginning on or after January 1, 2000, if the conditions of Subsection (4)(a) are met, the amount of income derived by a Ute tribal member:

(i) during a time period that the Ute tribal member resides on homesteaded land diminished from the Uintah and Ouray Reservation; and

(ii) from a source within the Uintah and Ouray Reservation.

(3) (a) For purposes of Subsection (2)(d), the amount of retirement income subtracted for taxpayers under 65 shall be the lesser of the amount included in federal taxable income, or $4,800, except that:

(i) for married taxpayers filing joint returns, for each $1 of adjusted gross income earned over $32,000, the amount of the retirement income exemption that may be subtracted shall be reduced by 50 cents;

(ii) for married taxpayers filing separate returns, for each $1 of adjusted gross income earned over $16,000, the amount of the retirement income exemption that may be subtracted shall be reduced by 50 cents; and

(iii) for individual taxpayers, for each $1 of adjusted gross income earned over $25,000, the amount of the retirement income exemption that may be subtracted shall be reduced by 50 cents.

(b) For purposes of Subsection (2)(e), the amount of the personal retirement exemption shall be further reduced according to the following schedule:

(i) for married taxpayers filing joint returns, for each $1 of adjusted gross income earned over $32,000, the amount of the personal retirement exemption shall be reduced by 50 cents;

(ii) for married taxpayers filing separate returns, for each $1 of adjusted gross income earned over $16,000, the amount of the personal retirement exemption shall be reduced by 50 cents; and

(iii) for individual taxpayers, for each $1 of adjusted gross income earned over $25,000, the amount of the personal retirement exemption shall be reduced by 50 cents.

(c) For purposes of Subsections (3)(a) and (b), adjusted gross income shall be calculated by adding to federal adjusted gross income any interest income not otherwise included in federal adjusted gross income.

(d) For purposes of determining ownership of items of retirement income common law doctrine will be applied in all cases even though some items may have originated from service or investments in a community property state. Amounts received by the spouse of a living retiree because of the retiree's having been employed in a community property state are not deductible as retirement income of such spouse.

(e) For purposes of Subsection (2)(h), a subtraction for an amount paid for health care insurance as defined in Title 31A, Chapter 1, General Provisions, is not allowed:

(i) for an amount that is reimbursed or funded in whole or in part by the federal government, the state, or an agency or instrumentality of the federal government or the state; and

(ii) for a taxpayer who is eligible to participate in a health plan maintained and funded in whole or in part by the taxpayer's employer or the taxpayer's spouse's employer.

(4) (a) A subtraction for an amount described in Subsection (2)(l) is allowed only if:

(i) the taxpayer is a Ute tribal member; and

(ii) the governor and the Ute tribe execute and maintain an agreement meeting the requirements of this Subsection (4).

(b) The agreement described in Subsection (4)(a):

(i) may not:

(A) authorize the state to impose a tax in addition to a tax imposed under this chapter;

(B) provide a subtraction under this section greater than or different from the subtraction described in Subsection (2)(l); or

(C) affect the power of the state to establish rates of taxation; and

(ii) shall:

(A) provide for the implementation of the subtraction described in Subsection (2)(l);

(B) be in writing;

(C) be signed by:

(I) the governor; and

(II) the chair of the Business Committee of the Ute tribe;

(D) be conditioned on obtaining any approval required by federal law; and

(E) state the effective date of the agreement.

(c) (i) The governor shall report to the commission by no later than February 1 of each year regarding whether or not an agreement meeting the requirements of this Subsection (4) is in effect.

(ii) If an agreement meeting the requirements of this Subsection (4) is terminated, the subtraction permitted under Subsection (2)(l) is not allowed for taxable years beginning on or after the January 1 following the termination of the agreement.

(d) For purposes of Subsection (2)(l) and in accordance with Title 63, Chapter 46a, Utah Administrative Rulemaking Act, the commission may make rules:

(i) for determining whether income is derived from a source within the Uintah and Ouray Reservation; and

(ii) that are substantially similar to how federal adjusted gross income derived from Utah sources is determined under Section 59-10-117.

(5) (a) For purposes of this Subsection (5), "Form 8814" means:

(i) the federal individual income tax Form 8814, Parents' Election To Report Child's Interest and Dividends; or

(ii) (A) for taxable years beginning on or after January 1, 2002, a form designated by the commission in accordance with Subsection (5)(a)(ii)(B) as being substantially similar to 2000 Form 8814 if for purposes of federal individual income taxes the information contained on 2000 Form 8814 is reported on a form other than Form 8814; and

(B) for purposes of Subsection (5)(a)(ii)(A) and in accordance with Title 63, Chapter 46a, Utah Administrative Rulemaking Act, the commission may make rules designating a form as being substantially similar to 2000 Form 8814 if for purposes of federal individual income taxes the information contained on 2000 Form 8814 is reported on a form other than Form 8814.

(b) The amount of a child's income added to adjusted gross income under Subsection (1)(c) is equal to the difference between:

(i) the lesser of:

(A) the base amount specified on Form 8814; and

(B) the sum of the following reported on Form 8814:

(I) the child's taxable interest;

(II) the child's ordinary dividends; and

(III) the child's capital gain distributions; and

(ii) the amount not taxed that is specified on Form 8814.

(6) Notwithstanding Subsection (1)(g), interest from bonds, notes, and other evidences of indebtedness issued by an entity described in Subsections (1)(g)(i) through (iv) may not be added to federal taxable income of a resident or nonresident individual if, as annually determined by the commission:

(a) for an entity described in Subsection (1)(g)(i) or (ii), the entity and all of the political subdivisions, agencies, or instrumentalities of the entity do not impose a tax based on income on any part of the bonds, notes, and other evidences of indebtedness of this state; or

(b) for an entity described in Subsection (1)(g)(iii) or (iv), the following do not impose a tax based on income on any part of the bonds, notes, and other evidences of indebtedness of this

state:

(i) the entity; or

(ii) (A) the state in which the entity is located; or

(B) the District of Columbia, if the entity is located within the District of Columbia.

Legislative Review Note
as of 6-20-01 8:58 AM

For purposes of the individual income tax, this legislation taxes interest from certain state and local bonds, notes, or other debts ("interest on debts") that are issued out of state while not taxing interest on debts issued in Utah. This differential taxation of interest on debts might be challenged as discriminatory under the Commerce Clause of the Constitution of the United States ("Commerce Clause"). Legal arguments exist in favor of and against the constitutionality of this legislation. However, a limited legal review of this issue has found that a significant majority of states tax interest on out of state debts, and that at least one court, the Ohio Court of Appeals, has upheld a similar tax which was challenged under the Commerce Clause.

Office of Legislative Research and General Counsel

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IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,

Respondents.

ON WRIT OF CERTIORARI
TO THE COURT OF APPEALS OF KENTUCKY

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

The dormant Commerce Clause should not be expanded beyond laws that involve differential treatment of private businesses. A capital markets free-for-all pitting the States and their 87,000 local governmental units against each other would be politically and economically destructive.

I. The Kentucky law does not "discriminate" against interstate commerce.

A. *United Haulers* makes private business taxes and tariff analogies inapposite.

Language from pre-*United Haulers* cases which struck down tax laws treating in-state private businesses more favorably than out-of-state private business competitors, Resp. Br. 12-17, does not apply to this case. Neither the holdings nor the language of those cases impeded the Court's conclusion in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Auth.*, 127 S.Ct. 1786, 1795 (2007), that laws which "benefit a clearly public facility, while treating all private companies exactly the same" do not "discriminate against interstate commerce." *United Haulers* expressly found a long line of cases invalidating local processing laws, "every one of which involved discrimination in favor of *private* enterprise" to be "readily distinguishable," and declined to extend those cases "to cover discrimination in favor of local government." *Id* at 1794 & n.4. There is no good reason to expand the language of tax cases involving private business enterprises, to a case which instead involves the financing of public projects and programs by State and local governments.

The notion that the Kentucky law is "equivalent to a tariff," Resp. Br. 18-19, similarly misses the point of *United Haulers*. If differential treatment of in-state trash processing services provided by a sovereign government, versus all other trash processing services, both in-state and out-of-state, does not constitute "discrimination against interstate commerce," then differential treatment of in-state interest paid by a sovereign government, versus all other interest paid by borrowers, both in-state and out-of-state, does not constitute "discrimination against interstate commerce."[1]

Nor does the analogy between the Kentucky law and a "protective tariff," the "paradigmatic example of a law discriminating against interstate commerce," *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 193 (1994), fit the facts of this case. The other 49 States, including all seven States that do not impose an income tax, are the out-of-state competitors whose bonds are subject to this imaginary tariff, yet they support Kentucky's position here. The in-state entity "pro-

---

[1] The Kentucky law thus satisfies the only prong of the four-part test of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), put in issue. The law also meets the other three requirements, *see* Pet. Br. 15-17, an observation not disputed by the Brief for Respondents. The belated suggestion that this case be remanded for a *Pike* balancing inquiry, *see* Resp. Br. 42-43, is neither warranted by the Court's decisions in tax cases over the past 30 years, *see* Pet. Br. 15 & n.14, nor necessary. The other 49 States and their local governments, as well as the Multistate Tax Commission, the National Association of State Treasurers, the Government Finance Officers Association, and the Securities Industry and Financial Markets Association, support Kentucky's position, negating any serious thought that the "burden imposed" on interstate commerce "is clearly excessive in relation to the putative local benefits" to Kentucky and its local governments of obtaining market access for their own bonds on favorable credit terms, *see Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).

tected" by this imaginary tariff is the sovereign government of Kentucky, not private businesses in the local dairy industry, the local liquor business, or the local stock exchange. The Court has pointedly noted that the "label of protectionism [is] of little help" when, as here, a State itself participates in the relevant market as a buyer or seller, *Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980); *accord, id.* at 447 n.1 (Powell, J., dissenting) ("By 'protectionism,' I refer to state policies designed to protect private economic interests within the State from the forces of the interstate market.")

The tariff analogy breaks down completely when we recognize that the law upheld in *United Haulers* was the exact equivalent of a "home embargo," the other chief exemplar of laws that "discriminate against interstate commerce." Similarly, the laws upheld in *Alexandria Scrap* and *White* foreclosed competition by out-of-state workers for in-state jobs just as effectively as a blockade at the state line.

Respondents' argument by analogy does not advance the analysis in this case. Laws "like" home embargoes and "like" border blockades have been upheld against dormant Commerce Clause challenges in those cases where the law favored a governmental entity (*United Haulers*) or where the State or local government was a market participant (*Reeves, Alexandria Scrap,* and *White*). This case involves both a law which favors only a State and its local governments, and a fact pattern in which the market participation of the State and its local governments is undisputed. No doubt the tax laws of 42 States treat sister State bond interest differently than interest paid on their own bonds. The issue is whether the reasoning of *United Haulers*, which speaks directly to a law that favors the State or local government itself, should chan-

nel the inquiry here, rather than cases involving different taxation of in-state versus out-of-state private business firms.[2]

B. "Public" means sovereign.

Respondents apparently concede that Kentucky's exemption for interest paid on Kentucky bonds does not violate

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[2] Amici Viard *et al.* argue that the state tax exemption for interest paid on "private activity bonds" should not be sustained under *United Haulers* because "private parties are the actual borrowers, not state or local governments." Viard Am. Cur. Br. 26. This is both an oversimplification and a non-sequitur. "Private activity bonds" issued by States and local governments finance projects and programs that serve overwhelmingly public purposes. Over 80% of all "private activity bonds" issued from 1996-2004 financed (i) tax exempt entity projects (primarily hospitals owned by 501(c)(3) entities), (ii) airports, (iii) multifamily housing projects and low-to-moderate income mortgage loan programs, and (iv) student loan programs. Belmonte, *Tax-Exempt Bonds, 2003-2004,* pp. 246, 255-256 (IRS Statistics of Income Division 2006); Belmonte, *Tax Exempt Bonds, 1996-2002,* pp. 151-158 (IRS Statistics of Income Division 2005). Congress has expressly authorized "private activity bonds" to be treated the same as "governmental bonds," *i.e.*, as a permissible use of public finance to support Congressionally specified types of projects that are in turn approved by State and local governments as means of accomplishing State and local governmental objectives. Such bonds must be approved by a State or local government, *see* 26 U.S.C. § 147(f), and are used to finance public infrastructure facilities such as docks and wharves, mass commuting facilities, solid waste disposal facilities, sewage facilities, and high-speed intercity rail facilities, *see* 26 U.S.C. § 142(a) (definition of "exempt facility bonds" classified as "private activity bonds"). The issue sought to be raised by Amici — that state tax exemptions for private activity bonds should be invalidated even though the exemption for other State and local bonds is sustained — was never raised in the courts below, and should not be considered by the Court now. Nothing in the record reveals whether the sister State bonds held by Respondents are governmental bonds or "private activity bonds," so Respondents have no standing to raise any claim related exclusively to "private activity bonds." *DaimlerChrysler Corp v. Cuno*, 126 S.Ct. 1854, 1867 (2006) ("a plaintiff must demonstrate standing for each claim he seeks to press").

the dormant Commerce Clause notwithstanding that Kentucky taxes interest paid on bonds or other debt obligations issued by all private borrowers, both in-state and out-of-state. Respondents argue nonetheless that Kentucky treats "similarly situated *public* entities" differently than Kentucky itself, Resp. Br. 24-25, an argument which begs the question whether sister States and local governments are "public" entities within Kentucky.

A sister State has no powers or responsibilities within Kentucky that are any different than the powers and responsibilities of a private business corporation in its business dealings with Kentucky creditors. The only relationship of the sister State to a Kentucky resident bondholder is contractual (debtor and creditor), not political (sovereign and citizen), just like the relationship of a private business debtor to its creditors. If the sister State defaults on its bonds, it may be sued in Kentucky just like any private business borrower.

Conversely, a sister State has none of the powers and responsibilities within Kentucky that are unique to "public" entities in Kentucky. A sister State has no police power in Kentucky, either directly through its law enforcement officers or indirectly through the extraterritorial application of its laws. A sister State cannot tax Kentucky real property or intangible property owned by a Kentucky resident.

That municipal bonds issued by different States may be "similar financial commodities traded in the same market," Resp. Br. 20-25, is irrelevant. The out-of-state trash processing facilities in *United Haulers* were no doubt "similar" to the in-state public facility, and were viable competitive alternatives in the market. The effort to distinguish *United Haulers* because it was a police power case rather than a tax case, Resp. Br. 31-32, is a distinction without a

difference. The claim that, unlike *United Haulers*, the burden of the Kentucky law falls on those who cannot vote in Kentucky, Resp. Br. 28-29, 32-33, is mystifying. Respondents and every other Kentucky resident bondholder 18 or over who pays tax on sister State bond interest, are eligible to vote in Kentucky. The arguments that a law which favors a sovereign government versus all other entities, nonetheless treats in-state and out-of-state entities in "a facially separate manner" and constitutes "simple economic protectionism" in violation of the dormant Commerce Clause, Resp. Br. 7, 12-17, 19-20, were considered and rejected in *United Haulers*.

Bonaparte, *Georgia v. Chattanooga*, *Nevada v. Hall*, and the Court's federalism cases, *see* Pet. Br. 29-35, apply the constitutional principle that one State is not a "public" entity within another State's jurisdiction, which Respondents try to deflect by noting that these decisions were not Commerce Clause cases. This mistakes the trees for the forest.

Bonaparte v. Tax Court, 104 U.S. (14 Otto) 592 (1881), is most instructive on the specific issue: "[I]f a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced interest; but, inasmuch as it cannot secure such exemption outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals." 104 U.S. at 595.

Respondents misread this crucial holding as referring to the taxing State, rather than the borrowing State, *see* Resp. Br. 40. That *Bonaparte* referred to the borrowing State is, however, clear from its holding in the immediately preceding paragraph that "the debtor State is in no respect his [the resident of the taxing State] sovereign, neither has it any of the attributes of sovereignty as to the debt it owes." 104 U.S. at

595.[3] It is the sister State as borrower that "cannot secure such exemption outside of its own jurisdiction," i.e., within Kentucky, is "subject to the same disabilities . . . as individuals" and other private borrowers within Kentucky.

Precisely because a debtor State with no sovereign power or responsibility within Kentucky is no different than a private business borrower, the Kentucky law challenged here should be sustained by a straightforward application of the *United Haulers* analysis. *United Haulers* would have reached the same result, by the same reasoning, if the out-of-state trash processing facilities had been owned by a sister State rather than a private business entity.

II. The alleged past harms and future benefits are unsupported in the record.

The Brief for Respondents claims that the Kentucky law "harms out-of-state issuers" and "out-of-state private sellers (underwriters, individuals, and investment funds)" by "blocking their access" to capital in Kentucky; "harms the

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[3] Respondents attempt to dilute *Bonaparte's* strength by pointing out that the 1876 Maryland property tax statute at issue in *Bonaparte* did not generally exempt State bonds, Resp. Br. 39-40. But no such exemption would have been necessary: Maryland had exempted its own bonds under the statutes authorizing the issuance of State bonds, *see, e.g., Proceedings and Acts of the [Maryland] General Assembly, March 30, 1868*, vol. 142, p. 2742, Laws of Maryland ch. 235 § 1 (amending and reenacting 1865 legislation authorizing Treasurer of the State "to issue bonds or certificates of debt, which said bonds or certificates of debt shall be exempt from State, county and municipal taxation . . . in the name and on behalf of the State of Maryland, to an amount not exceeding four millions of dollars"), available at Maryland Archives Online, http://aomol.net/megafile/msa/speccol/sc2900/sc2908/000001/000142/html/am142--2742.html.

States by compelling them" to enact laws "that decrease their net revenues"; and imposes a tariff "on out-of-state municipal bonds" that "hoards private capital" and "impedes interstate commerce" by "creating a barrier to the sale of out-of-state municipal bonds in Kentucky." Resp. Br. 9, 3, 18, 28, 26. Nothing in the record supports this jeremiad.

The only "out-of-state issuers" are the other States and their local governmental units. Nothing in the record demonstrates that the borrowing costs of other States, or the demand for their bonds, is in any way negatively affected by the Kentucky law. The other 49 States and their local governments support Kentucky's position as Amici Curiae.

Nothing in the record shows that any transactions of "underwriters" or "investment funds," either in the national bond market or with Kentucky investors, have been negatively affected by the Kentucky law. The Securities Industry and Financial Markets Association, whose members account for 90% of the nation's municipal bond underwriting and trading activity by volume, supports Kentucky's position as Amicus Curiae, as do several large fund sponsors and underwriters.

The only "individuals" in the record are Respondents themselves, who merely alleged that they paid Kentucky income tax on interest "derived from obligations of sister states," Complaint ¶ 14, J.A. 20, held by national bond mutual funds, Resp. Br. 4. Thus the composition of Respondents own portfolio — and the holdings of the national bond funds which account for about 20% of the market, or $500 billion — disprove rather than support Respondents' unsupported allegations that "access to capital" is blocked by the Kentucky exemption.

Respondents' pollyanna prediction that "the market will adjust quickly," Resp. Br. 46, if the Court invalidates the laws of 42 States, is neither credible nor supported by anything in the record.[4] If the municipal bond market has been "distorted" for decades by the laws of 42 States, it is difficult to imagine anything less than a sudden and violent reversal of the "inefficiencies" allegedly caused by the bond interest exemption, and we can be sure that it won't be pretty. This is no time for the Court to plunge public finance into cold, deep water with no idea of where the bottom is. "[T]he Court is institutionally unsuited to gather the facts upon which economic predictions can be made, and professionally untrained to make them." *General Motors Corp. v. Tracy*, 519 U.S. 278, 308 (1997).

Nor is any precipitous action necessary. Congress exhaustively studied the effects of State taxation on interstate commerce, and was fully informed about the differential taxation of sister State bond interest by the States, yet did nothing. *See* Pet. Br. 37-39. "The clear implication is that Congress finds the benefits" of the longstanding and widespread public finance practices of the States "well within the realm of what the States may reasonably promote and preserve." *General Motors*, at 305. If something now needs to be done to protect interstate commerce, Congress can do it.

It would be reckless to ignore the assessments of industry experts about the effects of invalidating the current system, which range from "significant disruption to municipal bond markets," National Association of State Treasurers

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[4] Nor are the assertions that Kentucky and the 49 other States "would all be better off" to abandon the policy decisions of their legislatures because the States "lose more revenue" through the exemption "than they gain by borrowing at lower rates," Resp. Br. 29-31.

Br. Am. Cur. 17, to "instability and price uncertainty in the national municipal bond market," Securities Industry and Financial Markets Association Br. Am. Cur. 4. Concern that "disruption to the existing municipal bond market, and the adjustment from a system that has prevailed for close to a century, would be substantial," National Federation of Municipal Analysts Br. Am. Cur. 16, is well-founded. Nor is it alarmist to fear that many local government issuers would be lost in the shuffle and might be deprived of market access altogether, with no alternative for the "funds that they otherwise would have been able to raise for needed improvements," Nuveen Investments, Inc. Br. Am. Cur. 18. In 2004, for example, almost half of the 14,419 new money long term tax exempt governmental bond issuances was for small bonds with an entire issue price of less than $1.0 million, and bonds with an entire issue price of less than $5.0 million accounted for about 75% of all issues, but only 6.7% of total proceeds. A total of 437 bond issues (3.0%) exceeded an issue price of $75 million, but the combined proceeds of this three percent comprised 59.1% of total proceeds. Belmonte, *Tax Exempt Bonds 2003-2004*, p. 252 (IRS Statistics of Income Division 2006). Hazarding the access to capital of thousands of local governments would not be judicious. "Still less is that risk justifiable in light of Congress' own power and institutional competence to decide upon and effectuate any desirable changes" in the public finance practices of the States "that [have] evolved" over the past 100 years. *General Motors*, at 309.

III. A tax exemption for bond interest received is equivalent to the payment of additional interest.

The economic reality of the municipal bond market is that both the federal exclusion and any applicable state level exemption are treated by creditor bondholders, debtor gov-

ernments, and all other market participants as the payment of additional interest.

A. All market participants treat the exemption as additional interest.

All the borrowers are sovereign States or their political subdivisions. Their chief financial officers regard the tax exemption as the payment of additional interest. *See* Br. Amicus Curiae National Association of State Treasurers 10 ("Kentucky's tax exemption is economically equivalent to a higher interest rate for Kentucky taxpayers.") All the lenders are bondholders, each of whom regards the exemption as the payment of additional interest. *See* Br. Amicus Curiae State of North Carolina, et al. 2 ("Bond purchasers . . . are motivated by the net return on the investment (i.e., the income stream produced by the bond less taxes imposed on this income).").

Municipal bond analysts, investment bankers, and other industry professionals all evaluate municipal bond investments by comparing the effective "taxable equivalent" yield or the "net after tax" yield on bonds to the returns available from competing investments. Temel, The Bond Market Association, *The Fundamentals of Municipal Bonds,* 28-29 (5th ed. 2001). That comparison treats the federal exclusion and the applicable state exemption as additional interest paid by the issuing State. *See* Br. Amicus Curiae Nuveen Investments, Inc. 3 ("the economic reality of the Kentucky exemption . . . is the fact that the exemption is the equivalent of an additional interest payment").

Respondents apparently agree. "Kentucky citizens are willing to accept less interest because they pay no state income tax on their earnings." Resp. Br. 6. That is, the tax

exemption is a substitute for additional interest. Respondents' industry source confirms that "the yields on [bonds] are therefore often articulated in terms of the taxable interest rate that would be required to provide the same after tax interest rate," and provides a "formula for determining the equivalent taxable interest rate."[5]

B. Economic substance is the touchstone.

The Court has often remarked that "it is the substance of the transaction, rather than the label attached to it, that governs Commerce Clause analysis," *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 99 n.11 (1984); "eschewed formalism for a sensitive, case-by-case analysis of purposes and effects," *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 201 (1994); and focused on the "practical operation" of a statute, *Best & Co. v. Maxwell*, 311 U.S. 454, 455-456 (1940).

The economic reality and practical effect of the exemption for bond interest should not be ignored. Rather, where a tax exemption applies directly and exclusively to the payment of money by a State to a third party, such as the payment of interest on the State's own debt obligations, the exemption should be treated as the payment of additional money by the State for Commerce Clause purposes, not as a "discriminatory tax."

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[5] Van Bergen, *Weighing the Tax Benefits of Municipal Securities*, Investopedia.com (July 28, 2004). The same formula to determine the equivalent taxable interest rate is illustrated and explained by the National Association of State Treasurers in its Amicus Curiae Brief in Support of Petitioners, at pages 5-6.

C. The exemption-equals-subsidy issue is not implicated here.

The Court's reluctance to equate tax exemptions for in-state private businesses, with direct subsidies to in-state private businesses, derives from the ineluctable tension between the "essential purpose" of state government and the principal objectives of dormant Commerce Clause adjudication. On the one hand the "essential and patently unobjectionable purpose of state government [is] to serve the citizens of the State." *Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980). Hence "a pure subsidy funded out of general revenue ordinarily imposes no burden on interstate commerce, but merely assists local business." *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 199 (1994). On the other hand are the dark side scenarios that if tax exemptions, standing alone, are (i) treated as a purchase of some service or product by the State "the 'market participant' exception would swallow the rule against discriminatory tax schemes," *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 594 (1997), or (ii) treated as direct subsidies, then tax exemptions for in-state private business that are denied to out-of-state private business entities or transactions could claim constitutional shelter under the rule that "direct subsidization of domestic industry does not ordinarily run afoul" of the dormant Commerce Clause, *New Energy Co. v. Limbach*, 486 U.S. 269, 277 (1988).

If the Court respects the economic reality of the bond market, it would do no violence to *New Energy*, *Camps Newfound*, or *West Lynn*, the three Commerce Clause cases in which the exemption-as-direct subsidy issue has been raised, or to the results or the reasoning of *Boston Stock Exchange*, *Bacchus*, or *Fulton Corp.*, all of which involved taxes on transactions between third parties or on property owned by

third parties, not transactions in which a State was directly involved.

D. Economic reality shows no market harms and no "discrimination."

Attention to the economic reality of the market should allay any concerns that the principal purposes of the dormant Commerce Clause are threatened or that there is any "discrimination" against interstate commerce.

At the very least, the economic reality of the bond market scuttles the notion that the exemption "distorts" or "balkanizes" the market. Investment capital seeks the highest "taxable equivalent yield" or "net after tax return" in any market, not just the municipal bond market. Investing to generate capital gain rather than ordinary income, and investment through a nontaxable ERISA account rather than a taxable brokerage account, are two familiar examples. This is no "distortion" or "inefficiency," it is economic reality. Capital is not "hoarded" if it seeks the highest "taxable equivalent yield," whether that yield is produced by the state bond interest exemption or the federal exclusion for bond interest. "Economic balkanization" is properly invoked only when subdivision of larger market territory produces weakness and instability. Yet the bond market functions well in providing the Nation's 87,000 local governments with essential financing.

At a greater magnification, an economic reality analysis forces the question whether a tax exemption applicable exclusively to the payment of interest owed by a borrower State, can ever correctly be said to "burden" or "discriminate" against interstate commerce. If Kentucky simply increased the contract interest rate on its bonds, and gave

Kentucky residents first dibs, it could not be seriously maintained that the dormant Commerce Clause would be transgressed. The economic substance and practical effect of the bond interest exemption — treated by all market participants as additional interest — are no different.

E. A *quid pro quo* tax exemption is not a "penalty."

The suggestion that the Kentucky exemption "penalizes" Respondents for their "participation in interstate commerce," Resp. Br. 4, misconceives the quid pro quo relationship between borrower States and creditor bondholders. The bondholder provides credit to Kentucky on favorable terms, and Kentucky in return makes cash interest payments to the bondholder and pays additional interest equal to the value of the tax exemption. By comparison, if a Kentucky resident chooses to loan money to California, there is no benefit to Kentucky, no quid pro quo, for which the tax exemption should be granted.[6]

IV. A market participant State may use its tax power as part of a quid pro quo.

Respondents apparently concede that Kentucky is a "market participant" in the municipal bond market (without reference to the tax exemption in issue). Language yanked out of context from *New Energy, South-Central Timber,* and

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[6] The same quid pro quo analysis undermines the argument for a "principle of competitive neutrality which prohibits States from taxing activity out of state while not taxing identical activity in state." The Tax Foundation Am. Cur. Br. 3-5. This idea has no application here: the out-of-state activity (a loan made to another State or any other debtor, for which Kentucky receives no consideration) is not identical to the activity in-state (a loan which makes capital available to Kentucky itself at favorable terms).

Camps Newfound, Resp. Br. 36-39, is therefore not helpful: those cases dealt exclusively with the question whether the State was a participant in the relevant market, not whether the dormant Commerce Clause limits the means by which the economic terms of that participation may be implemented.

South-Central Timber answers that question: "Our cases make clear that if a State is acting as a market participant . . . the dormant Commerce Clause places no limitation on its activities." 467 U.S. at 94.

The assertions that the market participation cases only "allow the State the rights of private parties," and only apply when "the State [is] acting as if it were a private party," Resp. Br. 3, 36, read *Reeves* backwards. *Reeves* held that when a State participates in a market as a buyer or seller (in that case, of state-manufactured cement), the State then "shares" with "private market participants" their "existing freedoms from federal constraints, including the inherent limits of the Commerce Clause." 447 U.S. at 439. There is no good reason this rule should suddenly be suspended when other States, each of which has the power to tax, are market participants as well. The contentions that "the Court has confined" the market participation doctrine to situations where the State participates "on the same terms as a private party," and that the Court "has held" the doctrine inapplicable when "the State imposes conditions only a state actor could impose," Resp. Br. 36, are not supported by citation to authority, because the Court has never said any such thing in its opinions.

To be sure, *New Energy* held that a tax credit, standing alone, could not constitute market participation by a State which was neither a buyer or a seller of a product, and referred to the "assessment and collection of taxes" as a "pri-

meval governmental activity." 486 U.S. at 277. The word "primeval" means "primordial" or "from the first," and it was in this context that *New Energy* rejected Ohio's attempt to treat naked taxation of sales of a product, as "participation" in the sale. *New Energy* simply held that exercise of a power that governments have always exercised, such as the taxing power or the police power — does not constitute "participation" by a State in a market in which the State is neither a buyer nor a seller of products or services.

Where, as here, Kentucky's market participation as a buyer or seller (without reference to the tax exemption in question) is uncontroverted, the dormant Commerce Clause simply does not apply. *See, e.g., White v. Massachusetts Council of Construction Employers,* 460 U.S. 204, 209-210 (1983). All the participants in the relevant market economically treat the tax exemption as additional interest or yield to the bondholder. It blinks reality to invoke the dormant Commerce Clause and prevent Kentucky (or any other State) from using its taxing power to pay, in part, for the use of capital. The Court has been careful to confirm that its cases involving private businesses do "not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry," *Boston Stock Exchange v. State Tax Comm'n,* 429 U.S. 318, 336 (1977). That limit on those cases applies even more forcefully when the States structure their tax systems to help them obtain essential financing for public projects and public works.

If the Commerce Clause does not constrain the States' use of their tax systems to compete with each other for new industry, or the widespread use of State tax incentives for job

creation, urban revitalization, or agricultural diversification,[7] then it would be anomalous indeed if the Commerce Clause prevents States from structuring their tax systems, vis-à-vis each other, to facilitate financing for public projects and programs.

V. Respondents' Import-Export Clause argument is neither timely nor applicable to interstate commerce or to interest payments.

Respondents' Import-Export Clause argument was neither presented to nor decided by the state courts, and should not be entertained by this Court on certiorari. *See, e.g., Kentucky v. Stincer,* 482 U.S. 730, 747 n.22 (1987). This is no "exceptional case" that might justify a departure from the rule. *McGoldrick v. Campagnie Generale*, 309 U.S. 430, 434 (1940) (refusing to consider respondents' Import-Export Clause argument raised for the first time on certiorari review of state court dormant Commerce Clause decision).

The longstanding construction of the Import-Export Clause is that the Clause applies only to imports from and exports to foreign countries, not to interstate commerce. *Woodruff v. Parham,* 75 U.S. (8 Wall.) 123 (1868). Even if this precedent were revisited, the scope of the Clause would extend only to (i) "imposts" and "duties" on (ii) "imports" and "exports." An income tax on annual interest from an in-

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[7] *See* Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 Harv. L. Rev. 377 (1996); Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879 (1986); Walter Hellerstein and Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 Cornell L.Rev. 789, 806-09 (1996).

tangible already owned by a resident bears little relationship to an "impost," which was "a tax levied on *goods* at the time of *importation*," *Camps Newfound*, 520 U.S. at 637 (Thomas, J., dissenting), or a "duty," which "though broader than an impost, which still a tax *on* particular *goods* or written instruments" such as bills of lading, *id.* at 639. Payment of a monetary obligation is not an "export" of money from the debtor's state or an "import" of money into the creditor's state.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

Respectfully submitted,

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In the Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

v.

GEORGE W. DAVIS and CATHERINE V. DAVIS,
Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF OF *AMICI CURIAE*, CHURCHILL TAX-FREE FUND OF KENTUCKY, HAWAIIAN TAX-FREE TRUST, NARRAGANSETT INSURED TAX-FREE INCOME FUND, TAX-FREE FUND FOR UTAH, TAX-FREE FUND OF COLORADO, TAX-FREE TRUST OF ARIZONA, TAX-FREE TRUST OF OREGON, HAWAII MUNICIPAL FUND, HAWAII INTERMEDIATE FUND, THE IDAHO TAX-EXEMPT FUND, OCEAN STATE TAX-EXEMPT FUND, BISHOP STREET HAWAII MUNICIPAL BOND FUND and WESTCORE COLORADO TAX-EXEMPT FUND IN SUPPORT OF PETITIONERS

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STATEMENT OF INTERESTS OF *AMICI CURIAE*[1]

Amici curiae are 13 State-specific municipal bond funds that collectively have more than 36,000 shareholders and combined assets of nearly $2.7 billion. Each fund concentrates on municipal bonds that are exempt from the income tax of a single State; each fund's shareholders overwhelmingly reside within that State. Several of the funds even compete with one another in a given State. But because their investors and the markets in which they function will be profoundly and negatively affected if the ruling below is affirmed in this case, they are jointly filing this brief.

Amici believe that the Davises are advancing, and the Kentucky Court of Appeals has accepted, a position that expands the dormant Commerce Clause radically and inappropriately. Through that proposed expansion, the Davises threaten to severely limit or even end a long-established practice common to 43 States – one that benefits residents of those States by fostering the only practical means by which to invest in a broad range of public improvements that directly enhance their local quality of life, without in any way impeding the flow of Commerce among the States. Pursuant to this Court's Rule 37.3, *amici* respectfully submit this brief in support of petitioners Department of Revenue of the Commonwealth of Kentucky and Finance and Administration Cabinet of the Commonwealth of Kentucky.

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[1] All parties have consented to the filing of this brief, and their letters are on file with the Clerk of this Court. Pursuant to Rule 37.6, *amici* state that no counsel for any party has authored this brief in whole or in part, and no person or entity other than the *amici* and their counsel contributed monetarily to the preparation or submission of this brief.

The 13 *amici* are similar in structure and purpose. Each invests primarily in investment-grade, tax-free municipal bond obligations of issuers within its State.[2] The bonds finance schools, low- and moderate-income housing, highways, hospitals, airports, water and sewer facilities and other public improvements. The funds have varying objectives but they all have two in common: preservation of capital, and providing income that is exempt from the income tax of the State on which each focuses. In that sense, each *amicus* is premised upon (and has a significant stake in) the tax structure that the Davises seek to upend.

The Aquila *amici* are seven State-specific municipal bond funds within the same group (or "complex"), the Aquila Group of Funds[sm]:

> **Churchill Tax-Free Fund of Kentucky** was created in 1987 for the benefit of Kentucky residents. Representative public improvements funded by bonds that it holds or has held include projects at the Jefferson County Hospital, the Warren County Judicial Center, Pendleton County High School and the Kentucky Rural Water Finance Corporation. As of June 30, 2007, the fund had more than 3,000 shareholders and assets in excess of $258 million.

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[2] Consistent with Utah law, *amicus* Tax-Free Fund For Utah also can invest in the bonds of nine States and the District of Columbia that reciprocate and treat Utah municipal bonds as tax-free. Utah Code Ann. § 59-10-114(1)(g). All *amici* also may invest in obligations of Puerto Rico, Guam and other U.S. territories, because their interest also is exempt from local taxation. However, those *amici* that purchase such bonds (and not all do), generally do so only when local bonds of suitable maturity and coupon rate are not available.

Hawaiian Tax-Free Trust was launched in 1985 for the benefit of Hawaii residents. Facilities financed in whole or in part by the bonds in which it invests include the Kamali'i Elementary School and Kahului Fire Station on Maui, the Kona Community Aquatic Center on the Big Island of Hawaii, highway H-3 on Oahu and the Kaui County Office Building. As of June 30, 2007, Hawaiian Tax-Free Trust had nearly 11,000 shareholders and assets of nearly $690 million.

Narragansett Insured Tax-Free Income Fund was created in 1992 for the benefit of Rhode Island residents. As of June 30, 2007, it had assets of nearly $148 million and nearly 1,900 shareholders. Representative projects financed include improvements at the Women & Infants Hospital and the Rhode Island Convention Center in Providence, various Rhode Island Clean Water and Pollution Control projects, and restoration and improvement projects at the Howard Center in Cranston, the largest facility of the State Department of Mental Health, Retardation and Hospitals.

Tax-Free Fund For Utah commenced operations in 1992 for the benefit of Utah residents. Representative projects financed include improvements at the Salt Lake City International Airport, the Municipal Building in Tooele and the Lehi City Recreation Center. As of June 30, 2007, Tax-Free Fund For Utah had total assets of over $226 million and more than 2,900 investors.

Tax-Free Fund of Colorado was created in 1987 for the benefit of Colorado residents. Projects financed have included improvements at the Poudre

Valley Hospital in Fort Collins, the Clear Creek School District, the El Paso County Judicial Building and the Highlands Ranch Recreation Center. As of June 30, 2007, its assets totaled more than $205 million, and it had more than 3,400 shareholders.

Tax-Free Trust of Arizona was launched in 1986 for the benefit of Arizona residents. Representative projects financed include improvements at the Theodore Roosevelt Dam across the Salt River, Sky Harbor Airport in Phoenix, Boswell Memorial Hospital and the Peoria Sports Complex. As of June 30, 2007, it had total assets of more than $328 million and more than 4,500 shareholders.

Tax-Free Trust of Oregon commenced operations in 1986 for the benefit of Oregon residents. Bonds of the fund have helped finance projects for the Clackamas County School District and Portland International Airport, improvements at the Rogue Valley Medical Center in Medford and wastewater treatment in Klamath Falls. As of June 30, 2007, it had approximately $414 million in assets and nearly 6,100 shareholders.

The First Pacific *amici* are two State-specific municipal bond funds within the First Pacific group of mutual funds:

Hawaii Municipal Fund was established in 1988 and was the first Hawaii tax-free, no-load mutual fund created by a local firm; **Hawaii Intermediate Fund** was established in 1994. Both were created for the benefit of Hawaii residents, and they have a combined shareholder base of 2,100 as of June 30, 2007, and nearly $161.5 million in total assets. Their bonds

have helped pay for local projects such as the Honolulu Police Department at Kapolei, the Hamilton Library at the University of Hawaii at Manoa and various freeway projects.

Four other *amici* join in this brief:

The Idaho Tax-Exempt Fund, part of the Saturna Capital fund complex, was created in 1987 for the benefit of Idaho residents. As of June 30, 2007, it had total assets of more than $9.5 million and 167 account holders. Public improvements financed include projects at the Kootenai-Shoshone Area Library, the Madison County Hospital and the Ketchum Water System.

Ocean State Tax-Exempt Fund was established in 1986 for the benefit of Rhode Island residents. As of June 30, 2007, it had 517 shareholders and net assets of $23.0 million, and has financed expansion of T. F. Green Airport, construction of the Kent County Courthouse, improvements at St. Antoine Residence, a nursing and rehabilitation center in North Smithfield; and projects at several educational institutions, including the University of Rhode Island and Brown University.

Bishop Street Hawaii Municipal Bond Fund was established in 1995 for the benefit of Hawaii residents. As of June 30, 2007 it had total assets of $171.9 million and 565 shareholders. Representative projects include improvements to the University of Hawaii, The Queen's Medical Center and Mid-Pacific Institute, a K-12 school in Honolulu.

Westcore Colorado Tax-Exempt Fund was established in 1991 for the benefit of Colorado residents. As of June 30, 2007 it had assets of $57.0 million and 201 shareholders. Its bonds have helped finance improvements at the Walker Field Airport in Grand Junction, the Colorado Water Resources Authority and the Yampa Valley Medical Center in Steamboat Springs.

The issue presented in this case is of critical importance to all 13 *amici*, since each exists largely, if not solely, because of the State income-tax exemptions at issue. As one economist with three decades of investment-industry experience has observed, a ruling affirming the Kentucky appellate court would "radically" change the municipal-investment landscape in the United States, replacing the current system with a nationwide municipal bond market and perhaps rendering obsolete State-specific funds such as *amici*. Milton Ezrati, "Muni Madness," *Economic Insights* (Lord Abbett & Co., L.L.C., June 15, 2007), *available at* http://www.lordabbett.com/us/insights/insights.jsp. Each of the *amici* has a significant interest in this case.

INTRODUCTION AND SUMMARY OF ARGUMENT

The widespread and longstanding practice among the States of granting income-tax exemption to interest derived from their own municipal bonds has given rise to the significant sector of the public-finance market in which *amici* and hundreds of similar funds function. State-specific municipal bond funds effectively provide the only practical means by which most individual investors may target their investments so as to help fund public projects that directly and effectively improve the quality of life where they and their families live. If the Kentucky appellate court's ruling is

affirmed, that regime almost certainly will atrophy, if not disappear entirely, and be replaced by a national municipal bond market – to the detriment of individual investors and local communities alike. Investors in State-specific bond funds such as *amici* also may have the value of their investments negatively affected due to a variety of possible factors, including significant redemption of fund shares as part of the transition to national bond funds.

Regardless of this Court's decision, municipalities of course will continue to borrow money (sell bonds) to pay for public-improvement projects. But if the Court affirms the ruling below, individual investors likely will be limited to only two channels of municipal bond investment. They will have to purchase bonds directly from issuers or through broker/dealers, which is cost-prohibitive for many individuals and generally limits their investment only to the single public project being funded, contrary to the principle of investment diversification. Or, they will have to invest in nationwide funds managed by advisers who may live hundreds, if not thousands, of miles from the individual investors and the communities seeking to borrow money – "[l]ittle reason will remain for state-specific strategies or funds." Ezrati, *supra*. Individual municipal bond investors in many States, particularly the less-populous States in which *amici* generally operate, will be deprived of the ability to invest in a diverse pool of bonds that fund a broad array of public improvements in the geographic area where they live, work and travel most frequently. Such a ruling would create disruption, and possible increased risk, among the very individuals who most wish to avoid both: the widows/widowers, retirees and other risk-averse investors who typically seek out, and benefit from, the professionally managed, diversified portfolios of investment-grade municipal bonds owned by *amici* and other State-specific funds.

Further, such a ruling also could place an impediment between municipal bond issuers and a major source of credit – their own citizens. Issuers would be forced into the nationwide bond market to borrow from investors in faraway places, who may have little familiarity with the issuer or with the local conditions that affect its creditworthiness, or the need for its new school, hospital, sewage-treatment plant, etc. Along the same lines, a purely nationwide bond market would eliminate the specialized intermediaries (such as *amici*) who by necessity familiarize themselves with public projects in their area to an extent that a distant player in most cases simply cannot. A portfolio manager who focuses exclusively on the municipal bonds of Hawaii has an incentive to learn all he or she can about every public project in that State, an incentive that a manager overseeing a nationwide fund simply does not have – absent a higher coupon rate paid by the issuer (and thus, its taxpayers) to catch the market's attention.

As this Court clarifies the outer boundaries (and perhaps the very existence) of the dormant Commerce Clause, it should not lose sight of the individuals who invest in State-specific municipal bond funds, the infrastructure needs of the communities in which they reside, or the manner in which the current regime of State tax-exemption facilitates their connection with one another.

ARGUMENT[3]

I. State-Specific Bond Funds Facilitate Investment In Municipal Bonds by Providing Individuals and Issuers With a Unique Mechanism by Which Investment May Occur In a Range of Public-Improvement Projects in Their Geographic Area.

A. State-Specific Funds Occupy a Unique But Important Niche of the Municipal-Bond Fund Market.

Municipal bonds are debt securities issued by governmental units to raise funds used to build roads, bridges, schools and all manner of public improvements. Their history in the United States dates to the 1820s, when booming cities needed capital for various public projects. Robert Zipf, *How the Bond Market Works* 82 (1997). In 1843, when records were first kept, total outstanding municipal debt in the United States was $25 million, and by 1900 that figure had risen to $2 billion. *Id.*

The municipal bond market today is exceedingly large in scope. As of May 31, 2007, the nation's municipal bond funds (national and State-specific) had total net assets of $378.6 billion, "Trends in Mutual Fund Investing: May 2007" (ICI June 29, 2007), *available at* http://www.ici.org/home/trends_05_07.html, and from 2000-

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[3] Mindful that the parties and other *amici* will thoroughly brief the legal issues in this case, and also of the admonition of Rule 37.1, *amici* in this brief primarily will present relevant factual material that may not have been brought to the Court's attention. Stern, Gressman et. al., *Supreme Court Practice* 664 (8th ed. 2002).

2006, State and local governments issued approximately $2.78 *trillion* of tax-exempt securities – more than 85 percent of which ($2.39 trillion) consisted of bonds. *See*, *The Bond Buyer/Thomson Financial 2007 Yearbook* 4-13 (Source Media 2007). In 2006, $388.6 billion of municipal bonds were issued, down slightly from the record-setting $408.3 billion sold in 2005 but still the second-highest year ever, measured by volume. Michael Scarchilli, "The Market in Review," *The Bond Buyer/Thomson Financial 2007 Yearbook* 2. As of 2001, total municipal bond debt outstanding in the country equaled roughly 18 percent of U.S. gross domestic product. Bill Simonson, Mark D. Robbins and Lee Helgerson, *The Influence of Jurisdiction Size and Sale Type on Municipal Bond Interest Rates: An Empirical Analysis*, 61 PUBLIC ADMIN. REVIEW 709 (November/December 2001).

A significant portion of the municipal-bond market is occupied by State-specific municipal bond funds, mutual funds established for the primary purpose of allowing investors to take advantage of the State income-tax exemption that the Davises challenge as unconstitutional.[4] Such funds

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[4] A mutual fund is an investment company that buys a portfolio of securities selected by a professional investment adviser to meet a specified financial goal. There is no limit on the number of shares a mutual fund may issue, and it is referred to as an "open-end" fund for two main reasons: 1) it is required to redeem (buy back) outstanding shares at any time, at their current net asset value, and 2) virtually all mutual funds continuously offer their shares to the public. A "closed-end" fund, in contrast, also holds investments that are professionally managed in accordance with its investment objectives, but it issues a fixed number of shares that trade on a stock exchange or an over-the-counter market. *Investment Company Fact Book* 145 (ICI 2007), *available at* http://www.ici.org/home/2007_factbook.pdf. Each *amicus* is an open-end fund.

trace their origin to 1976, when the Internal Revenue Service first allowed the tax-exempt feature of municipal bonds to flow through to individual investors, resulting in the prompt creation of a number of municipal bond mutual funds. Robert Zipf, *How the Municipal Bond Market Works* 160-161 (1995). In 2006 there were 481 open-ended municipal bond mutual funds, *Investment Company Fact Book* 98 (ICI 2007), *available at* http://www.ici.org/home/2007_factbook.pdf, and at the close of 2005, 13 percent of all outstanding municipal bonds were held by State-specific mutual funds. Ethan Yale and Brian Galle, *Muni Bonds and the Commerce Clause After* United Haulers, 115 TAX NOTES 1037, 1038 (June 11, 2007) (citation omitted). The 90 fund complexes offering a total of 642 closed- and open-ended single-State municipal bond funds in the United States as of May 31, 2007 had aggregate assets of $192.2 billion. (Appendix A, "State Specific Municipal Bond Funds, By State (Open-End and Closed-End Funds, as of May 31, 2007") (data provided by Avi Nachmany, Director of Research, Strategic Insight Mutual Fund Research and Consulting).

Most State-specific funds focus on the States that issue many municipal bonds, impose relatively high income tax and/or have a significant population of high-income residents. (An IRS study noted that during 1996-2002, slightly more than 50 percent of the $750.7 billion in new money long-term bonds issued came from just eight States: California, New York, Texas, Illinois, Florida, Pennsylvania, New Jersey and Michigan. Cynthia Belmonte, *Tax Exempt Bonds 1996-2002* 151 (*SOI Bulletin* Summer 2005), *available at* http://www.irs.gov/pub/irs-soi/02govbnd.pdf). Accordingly, residents of only about a dozen states have what could be termed a "good selection" of single-State municipal bond funds from which to choose. Kiplinger Washington Editors,

"Win With Home-State Muni Bond Funds," 11 *Kiplinger's Retirement Report* (December 2004).

Amici, however, follow a somewhat different approach, and fill a significant niche in the State-specific municipal bond market that otherwise would be underserved. Of the eight States in which they operate, only two (Colorado and Arizona) are served by more than a dozen State-specific funds. (Appendix A). The remaining six States are among those that much of the market overlooks. For instance, *amici* Hawaiian Tax-Free Trust, Bishop Street Municipal Bond Fund and the two First Pacific funds together account for four of the six State-specific bond funds in Hawaii, and hold 90 percent of the total $1.1 billion assets in Hawaiian bond funds. *Id.* Similarly, *amici* Narragansett and Ocean State comprise half of the Rhode Island bond funds and hold nearly 50 percent of the assets in such funds. *Amici* Idaho Tax-Exempt Fund is one of only two such funds in that State, while *amici* Tax-Free Fund For Utah is the *only* State-specific municipal bond fund for residents of Utah. *Id.*

Amici also focus heavily on local fund management – they represent fully 100 percent of the funds in Hawaii and Rhode Island run by local portfolio managers, and all but one of the 13 *amici* have at least one portfolio manager who lives in and has longstanding ties to the State. Researchers have found a "strong geographic link between mutual fund investment and performance," Joshua D. Coval and Tobias J. Moskowitz, *The Geography of Investment: Informed Trading and Asset Prices*, 109 JOURNAL OF POLITICAL ECONOMY 811 (University of Chicago 2001), *available at http://faculty.chicagogsb.edu/tobias.moskowitz/research/GeogInv.pdf* (locally based fund managers earn "substantial abnormal returns" due to increased informational opportunities with regard to local stocks). Though the Chicago study dealt with

stock mutual funds, its reasoning should apply with equal force to local portfolio management of all types of investments. The study found that "fund managers are exploiting informational advantages in their selections of nearby stocks" via their increased access to company officials and information, *Id.* at 812 – advantages that also are available to portfolio managers with regard to municipal bonds.

State-specific funds such as *amici* serve an important function in the municipal bond market.

B. A Ruling That State Tax Exemption Violates the Dormant Commerce Clause Will Harm State-Specific Municipal Bond Fund Investors and Municipal Bond Issuers.

Municipal bond holders by definition are likely to be conservative in their investment approach. Daniel Kadlec, "Light These," *Time*, April 27, 2003, *available at* www.time.com/time/magazine/article/0,9171,447208,00.html. As individuals grow older, the percentage of their mutual-fund assets held in *all* types of bond funds, municipal and non-municipal (as opposed to equity, hybrid, money-market or other types of funds), tends to increase. According to an ICI study, in both the under-40 and 40-to-64-year-old age groups, 13 percent of household mutual-fund assets are held in bond funds – but for those aged 65 and over, the figure jumps to 21 percent. *Profile of Mutual Fund Shareholders* 116 (Investment Company Institute, Fall 2004), *available at* http://www.ici.org/pdf/rpt_profile04.pdf. Without doubt, as the baby boom generation ages they will swell the ranks of the latter group. And, while bond holders in general are conservative and risk-averse, municipal bond holders are even more so. "The typical muni investor values stability above

all." *Kadlec*, *supra*. Tax advantages and low degree of risk are precisely what make municipal bonds an attractive investment to such individuals. Dean Arthur Warga, "An Overview of the Regulation of Bond Markets," (Report to the Senate Banking Committee), June 17, 2004, *available at* http://banking.senate.gov/_files/warga.pdf.

The shareholders of *amici* are no different in their desire for safety and stability. They have decided to invest in one of the *amici* in large part because it primarily buys and holds investment-grade bonds. *Amicus* Churchill Tax-Free Fund of Kentucky has found that its typical shareholder is a retiree who took risks earlier in life but has amassed a nest egg that he or she wants to preserve, and thus the fund stresses stability over performance. Jacob Fine, *Aquila's Local Success*, The Bond Buyer, October 3, 2003, at 1, *available at* http://www.aquilafunds.com/Download/BondBuyer.pdf. In the extensive experience of *amici*, investors in State-specific municipal bond funds have an additional interest beyond the security and stability sought by most bond holders, even many municipal bond holders. Investors in State-specific funds actively foster a connection with the communities in which they live, and want not only to see their funds invested conservatively, but also to see those investments improve the roads, schools, hospitals and other infrastructure that they and their spouses, children and grandchildren use. As the President of the Aquila Group of Funds noted, "[W]hat you're doing is you're investing in that school down the street that the little kids next door go to...or you're investing in the hospital that you just took your husband or mother to." *Id.*

In that sense, State-specific municipal bond funds play an important role: they allow smaller investors to invest in a single security (fund shares) that diversifies their investment among a broad range of public-improvement projects in the

area where they live – something that otherwise would generally be available only to the very high net worth investor. Indeed, "[f]or most retirees, mutual funds are the most practical and cost-effective way of assembling a diversified portfolio of State-specific bonds." Kiplinger Washington Editors, *supra*. There is direct proof that at least some individuals invest for those reasons. One shareholder of *amicus* Churchill Tax-Free Fund of Kentucky noted several years ago that she likes the fact that the fund specifically invests in improving Kentucky's roads, because those roads allow her family to stay in touch with one another. Fine, *supra*, *see also* Appendix B, Letter of Barbara Gower. As she wrote in recounting a harrowing incident where her parents rolled their Model A Ford after rounding a curve to find a cow in the middle of a darkened two-lane road, "Hooray for Kentucky Turnpikes." Appendix B.[5]

Corresponding with the desire of some individuals to focus their investments on local public works, State-specific funds work actively to foster and maintain connections with their communities. As noted, all but one of 13 *amici* have a portfolio manager who lives in and has longstanding ties to their State (the other has a manager in an adjacent State, who stays abreast of developments in the fund's State). Several portfolio managers of the Aquila *amici* have served in that capacity for their fund since its inception, in some cases dating to the mid-1980s. Likewise, the president of the First Pacific *amici* left his job at the Honolulu office of a Wall Street firm in 1988 to set up his own business, offering fellow Hawaii residents a no-load mutual fund with tax-free income opportunities. In short, State-specific funds such as *amici*

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[5] Mrs. Gower's note was referenced in the 2003 Bond Buyer article, and plainly predates the Davises' action.

provide investors with conservative investments that generate income free from both regular Federal and State income tax, and also enhance the quality of life in the communities in which bond holders and many fund managers alike reside. And they allow these stability-seeking investors to keep an eye on how their money is being used, since their local government officials are the ones in charge of the public-improvement projects.

Economic studies confirm what common sense and the experience of *amici* suggests: people favor familiar investments, and are reluctant to invest in the unfamiliar. Gur Huberman, *Familiarity Breeds Investment*, 14 THE REVIEW OF FINANCIAL STUDIES 659, 665 (Fall 2001). Professor Huberman studied the geographic pattern in 1996 of shareholders of the seven Regional Bell Operating Companies ("RBOCs") created from the breakup of AT&T 12 years earlier. While the stock of each RBOC was equally accessible to the investing public nationwide, since each had large market capitalization and was traded on the New York Stock Exchange, in 49 of the 50 States (excepting Montana) more people held shares of their local RBOC than of any other single RBOC. *Id* at 660. In plain terms, "[p]eople root for the home team, and feel comfortable investing their money in a business that is visible to them." *Id* at 659.

This is not a recent development in our Republic:

> The native of New England is attached to his township because it is independent and free: his co-operation in its affairs ensures his attachment to its interests, the well-being it affords him secures his affection; and its welfare is the aim of his ambition and his future exertions. He takes a part in every occurrence in the place; he practices the art of government in the small

> sphere within his reach....Alexis de Tocqueville, DEMOCRACY IN AMERICA 68 (Alfred A. Knopf ed. 1994) (1835, 1840).

But while the propensity to invest in the familiar is not new, it bears profound implications in the context of this case. If this Court affirms the Kentucky appellate court and its ruling results in the predicted partial or total eclipse of State-specific funds by a nationwide municipal bond market, civic-minded municipal bond investors who wish to invest in a range of local public improvements generally will have few options. They will be limited either to direct purchases of bonds from an issuer or broker/dealers – which in many cases are cost-prohibitive for an individual, and in any event allow for investment only in one specific public-improvement project, contrary to the principle of investment diversification – or else they will be forced into the nationwide municipal bond funds. Ezrati, *supra*.

In that new national municipal bond bazaar, dominated by the huge, nationally known fund complexes, investors' dollars will be sent off to a portfolio manager sitting in a perhaps distant office, intermingled with the funds of thousands if not millions of other investors from around the country, and used to purchase municipal bonds from places they may never have heard of, to finance public improvements they will never see. Any attempt by an individual to target her investment toward a range of public improvements in her hometown, county or State will become hopelessly diluted, a few drops of water sprinkled into a nationwide sea of capital. In that circumstance, it is conceivable that at least some investors, deprived of the intangible benefit they receive from "rooting for the home team" with their investment dollars, will depart the municipal bond market altogether, in favor of some other investment(s) that may well be riskier than what the investor

would prefer to buy and hold. Further, the professional fund managers who invest the money of those who *do* remain will have a greatly decreased incentive to investigate the bonds of issuers that are small and/or located in distant places – rather than the more liquid bonds of large issuers – absent the premium of a higher coupon rate.

This problem is especially acute in the thinly populated and/or geographically remote States on which *amici* largely focus their operations, since a fund manager on Wall Street, or an investor in Chicago, may well have little interest when Boone County, Kentucky wishes to build a new sewage-treatment plant, or when the main street in Bisbee, Arizona needs to add a turn lane. Those communities (at least under normal circumstances) still will be able to sell bonds for their projects, but may well have to pay a higher interest rate to entice far-off buyers to purchase them, and/or pay for one or more ratings from the major bond-rating services. The Davises can point to no legal or factual support warranting the upheaval and uncertainty that their proposed expansion of the dormant Commerce Clause would impose on investors in State-specific, high-grade municipal bond funds – the most risk-averse segment of an already risk-averse group.[6]

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[6] Nor can the Davises deny that disruption would ensue: In anticipation of this Court's ruling, some tax lawyers already are advising clients to file State refund claims to preserve timeliness issues – and alternatively, raising the specter of retroactivity that could result in bond owners "getting a tax bill for three years worth of income tax on municipal bond interest that was previously exempt." Timothy P. Noonan and David Martin, *U.S. Supreme Court's Decision to Hear Municipal Bond Case Raises Constitutional, Procedural Questions*, 44 STATE TAX NOTES 969, 970-971 (Tax Analysts June 25, 2007), *available at* http://hodgsonruss.com/files/1_2_1/TPN_Notes/Notes_Bond_Case.pdf.

Of greater potential risk, the elimination of specialized intermediaries such as *amici* and their locally based, professional portfolio managers, could drive the very people who seek the safety and stability of bonds into a marketplace that, for the individual investor, is decidedly user-unfriendly. As one study noted, prior to implementation of NASD's transparency-reform program "[t]he corporate bond market historically has been one of the least transparent securities markets in the United States, with neither pre-trade nor post-trade transparency." Michael A. Goldstein, Elizabeth S. Hotchkiss and Eric R. Sirri, *Transparency and Liquidity: A Controlled Experiment on Corporate Bonds*, 20 REVIEW OF FIN. STUDIES 235 (March 2007). If anything, municipal bonds are even worse in that regard: "Relatively small issue sizes and obscure details about specific revenue projects or taxing authority rights and privileges make these securities even less transparent that most corporates." Warga, *supra* at 8. The bond market historically has lacked things like annual reports from issuers, widely available price reports and other indicia of transparency that are commonplace with stocks. The reforms of earlier this decade aimed at increasing municipal bond market transparency are "at best having a slow-moving effect on the cost structure for municipal trades," a fact that "simply reflects the fact that the market is geared to institutional trading and/or is dealing with complex securities that require a costly trading environment." *Id* at 9. But if the Davises' position is accepted, and it leads (as some predict) to the obsolescence of State-specific funds such as *amici*, that would remove the very locally based portfolio managers who serve to bridge the gap between the bond market and the individuals who seek its wares. That truly would be an undesirable effect.

The Davises may argue that elimination of State tax exemption will simply mean that the municipal bonds now

purchased for the most part by *amici* and other State-specific bond funds instead will be purchased by the nationwide funds. But the prospects of such a rosy outcome in the States serviced by *amici* appear far from certain. As of July 12, 2007, four large, well-known fund complexes and *amici* had State-specific municipal bond funds in the following States; those served by none of the former are emphasized: [7]

Fidelity	Vanguard	American funds	Putnam	*Amici*
Arizona	California	California	Arizona	Arizona
California	Florida	Maryland	California	***Colorado***
Conn.	Mass.	Virginia	Mass.	***Hawaii***
Florida	New Jersey		Michigan	***Idaho***
Maryland	New York		Minn.	***Kentucky***
Mass.	Ohio		New Jersey	***Oregon***
Michigan	Penn.		New York	***R.I.***
Minnesota			Ohio	***Utah***
New Jersey			Penn.	
New York				
Ohio				
Penn.				

Other than Arizona, there is not a single State among the eight served by *amici* in which the above large national fund complexes now offer a State-specific municipal bond fund. Instead, they focus on 13 of the most heavily populated States. State-specific funds such as *amici* have created a unique and important market channel for both investors and issuing governmental entities, in which the national market to

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[7] Data retrieved from www.fidelity.com, www.vanguard.com, www.americanfunds.com and www.putnam.com on July 12, 2007.

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date generally has shown little or no interest. If large national fund complexes to date have been generally uninterested in servicing such investors who wish to target their investments to their home area, the prediction that they will suddenly become interested if tax-exemption is held unconstitutional, seems questionable at best.

Nor can the Davises' position be justified by arguing that State-specific funds can simply transform themselves into national bond funds if this Court extends the dormant Commerce Clause to bar State-specific tax exemptions. Many State-specific municipal bond funds, including several of the *amici*, have as a fundamental policy that they will invest primarily in their State's "obligations" (which are defined to include certain territorial bonds, as noted *supra* in fn 2). Under § 13(a)(3) of the Investment Company Act, 15 U.S.C. § 80a-13(a)(3), changes to fundamental investment policies must be approved by the vote of a majority of the fund's outstanding voting securities. That would entail the significant additional expense of a proxy solicitation of shareholders, since many bond funds are not required to, and do not, hold annual meetings. Proxy solicitations are an expensive and time-consuming process for any mutual fund, and with shares increasingly held in broker accounts, funds frequently lack specific knowledge of who their shareholders even are. Further, under SEC rules these funds also would have to change their names to reflect their new national scope, causing a loss of the goodwill they have built up – in the case of several *amici*, more than 20 years' worth. Given the lower yields inherent in tax-free bond funds, most State-specific municipal bond funds would find it difficult, if not impossible, to justify the economic expense of becoming national in scope – particularly since these very expenses would make their yields uncompetitive with existing national funds.

The Davises' position also ignores the hardship that a transition to national bond funds could cause to current investors in State-specific funds such as *amici*. Large-scale bond redemptions that may be needed to accommodate departing investors could have a significant negative effect on the net asset values of State-specific funds, and thus on the value of investors' nest eggs. *See* Mark W. Riepe, *How Important Is a Mutual Fund's Tax Efficiency?* 13 JOURNAL OF FINANCIAL PLANNING 42 (August 2000), *available at* http://www.fpanet.org/journal/articles/2000_issues/jfp0800-art8.cfm (with significant redemptions a mutual fund may need to sell many securities, triggering large taxable distributions to remaining shareholders). A ruling affirming the Kentucky appellate court conceivably could set this process in motion, with unpredictable effects on fund values and those investors who choose to stay put. And those investors who "vote with their feet" after such a ruling, by leaving fund complexes of *amici* and other State-specific funds in favor of the market-dominating multi-State or national fund families, could be exposed to a new round of sales charges and costs that they otherwise would not incur. Finally, a ruling affirming the Kentucky court's finding of unconstitutionality also could cause fund portfolios to suffer via decreased value due to their repricing in the national market, i.e. once they are stripped of the benefit of double tax exemption.

In sum, if this Court affirms the Kentucky appellate court's interpretation of the dormant Commerce Clause, the likely consequence will be the dismantlement of time-honored arrangements that have greatly benefited State and municipal authorities and their citizens – who both invest in, and benefit from, the public improvements that municipal bonds finance. Given the scope of the harm that could result to investors, issuers and funds such as *amici*, and the absence of any

corresponding benefit, the Davises' position cannot satisfy *any* balancing test that may be employed in determining whether the dormant Commerce Clause has any application. The pervasiveness and extent of the harm that could result is in fact proof that the Davises' position cannot be correct as a matter of Constitutional interpretation.

The current taxation and municipal bond regime works well. Over the course of nearly a century, the vast majority of States have chosen through their elected representatives to exempt from taxation interest on bonds issued within their borders, so as to further encourage residents to invest in their community and State. Nothing even remotely like the retaliatory trade wars that the dormant Commerce Clause is aimed at stopping has resulted. There is no reason to upset the current taxation system, or write what could be the epitaph of State-specific municipal bond funds.

CONCLUSION

For the foregoing reasons, *amici* request that the January 6, 2006 Judgment of the Commonwealth of Kentucky Court of Appeals be reversed.

Respectfully submitted,

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July 19, 2007

APPENDICES

APPENDIX A

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Fund Assets ($Mil)
Dupree AL TxFr Income	Alabama	11.8
Eaton Vance AL Muni	Alabama	58.9
Evergreen AL Muni Bond	Alabama	37.8
Franklin AL TxFr Income	Alabama	279.7
Government Street AL TxFr Bond	Alabama	25.5
MFS Muni AL	Alabama	83.3
AB Muni Income II AZ	Arizona	208.4
Am Cent AZ Municipal Bond	Arizona	52.7
Delaware Inv AZ Muni Income	Arizona	60.5
Delaware TxFr AZ	Arizona	150.0
Eaton Vance AZ Muni	Arizona	102.0
Fidelity AZ Municipal Income	Arizona	127.5
First Am AZ TxFr	Arizona	28.4
First Inv Multi Ins TxEx AZ	Arizona	16.7
Franklin AZ TxFr Income	Arizona	1,032.9
JPMorgan AZ Muni Bond	Arizona	148.3
MuniYield AZ	Arizona	94.3
Northern AZ TxEx	Arizona	55.6
Nuveen AZ Dvdnd Advtg Muni	Arizona	35.0
Nuveen AZ Dvdnd Advtg Muni 2	Arizona	55.3
Nuveen AZ Dvdnd Advtg Muni 3	Arizona	66.5
Nuveen AZ Muni Bd	Arizona	88.1

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Nuveen AZ Prem Inc Muni	Arizona	93.8
Putnam AZ TxEx	Arizona	84.0
Rochester AZ Muni	Arizona	15.6
Tax Free Trust Of Arizona	Arizona	334.4
Eaton Vance AR Muni	Arkansas	66.5
MFS Muni AR	Arkansas	136.6
AB Muni Income CA	California	778.4
AB Muni Income Insured CA	California	110.0
Alliance CA Muni Income	California	209.4
Am Cent CA Hi Yield Municipal	California	655.0
Am Cent CA Limtd Term TxFr	California	140.4
Am Cent CA Long Term TxFr	California	451.2
Am Cent CA TxFr Bond	California	460.0
BlackRock CA Ins Muni 2008	California	263.7
BlackRock CA Ins Muni Inc	California	126.6
BlackRock CA Insrd Muni Bd	California	397.7
BlackRock CA Invest Qual Muni	California	21.8
BlackRock CA Muni 2018	California	152.1
BlackRock CA Muni Bond	California	83.2
BlackRock CA Muni Inc	California	363.3
BlackRock CA Muni Inc II	California	197.4
CA TxEx Bond	California	1,711.2
CNI Charter CA TxEx Bond	California	32.2
California Insured Intrmd	California	17.7
California TxFr Income	California	122.1
Colonial CA Insured Muni	California	65.7

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Columbia CA Intrmd Muni	California	143.7
Columbia CA Tax Exempt	California	445.1
DWS CA TxFr Income	California	831.0
Delaware TxFr CA	California	109.4
Dreyfus CA Intrmd Muni Bond	California	234.7
Dreyfus Premr CA TxEx Bond	California	1,227.7
Dryden Muni CA Income	California	238.2
Eaton Vance CA Ltd Muni	California	35.9
Eaton Vance CA Muni	California	282.9
Eaton Vance CA Muni Inc Trust	California	173.2
Eaton Vance Ins CA Muni Bd II	California	92.7
Eaton Vance Ins CA Muni Bond	California	524.3
Evergreen CA Muni Bond	California	495.0
Excelsior CA Sht Int TxEx Inc	California	52.8
Federated CA Muni Income	California	83.8
Fidelity CA Municipal Income	California	1,666.6
Fidelity CA Sht Intrmd TxFr Bo	California	108.6
First Am CA Intrmd TxFr	California	60.1
First Am CA TxFr	California	37.4
First Inv Multi Ins TxEx CA	California	27.9
Franklin CA High Yield Muni	California	1,659.6
Franklin CA Insrd TxFr Income	California	2,018.3
Franklin CA Intmd TxFr	California	485.1
Franklin CA Ltd Trm TxFr Inc	California	11.6
Franklin CA TxFr Income	California	14,121.0
GS CA Intrmd AMT Free Muni	California	77.8
Hartford TxFr CA	California	38.9
HighMark CA Intrmd TxFr	California	123.5

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total assets ($bil)
J Hancock CA TxFr Income	California	334.7
JPMorgan CA TxFr Bond	California	158.2
Legg Mason P Intrmd CA Muni	California	65.9
Legg Mason P Muni Bond CA	California	791.6
Lord Abbett TxFr CA Income	California	170.8
MFS Muni CA	California	443.9
ML CA Muni Holdings Insrd	California	697.6
MSDW CA Insured	California	228.1
MSDW CA Quality Muni Sec	California	190.9
MSDW Insured CA Muni Sec	California	51.9
Managers CA Intrmd TxFr	California	34.9
Morgan Stanley CA TxFr	California	479.5
MuniYield CA	California	456.1
MuniYield CA Insured	California	638.1
NB CA Intermediate Muni	California	158.4
Northern CA Intrmd TxEx	California	118.6
Northern CA TxEx	California	119.4
Nuveen CA Dvdnd Advtg Muni	California	536.3
Nuveen CA Dvdnd Advtg Muni 2	California	335.1
Nuveen CA Dvdnd Advtg Muni 3	California	547.8
Nuveen CA High Yield Muni Bd	California	33.9
Nuveen CA Insured Muni Bond	California	240.1
Nuveen CA Investment Qual Muni	California	319.5
Nuveen CA Muni Bond	California	298.5
Nuveen CA Muni Mkt Oppty	California	194.8
Nuveen CA Muni Value	California	253.9
Nuveen CA Performance Plus	California	304.8
Nuveen CA Premium Income	California	126.9

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Nuveen CA Quality Income Muni	California	524.6
Nuveen CA Select Qual Muni	California	546.3
Nuveen CA Select TxFr Income	California	91.8
Nuveen Insrd CA Dvdnd Advtg	California	353.3
Nuveen Insrd CA Premium Inc	California	144.2
Nuveen Insrd CA Premium Inc 2	California	284.2
Nuveen Insrd CA TxFr Advtg	California	132.8
Oppenheimer CA Municipal	California	2,399.9
Oppenheimer Ltd Trm CA Muni	California	248.7
PIF CA Insrd Intrmd Muni	California	95.9
PIF CA Muni	California	391.0
PIMCO CA Intrmd Muni Bond	California	142.2
PIMCO CA Muni Income	California	414.5
PIMCO CA Muni Income II	California	715.3
PIMCO CA Muni Income III	California	504.1
PIMCO CA Sht Dura Muni Inc	California	9.9
Parnassus CA TxFr	California	15.4
Payden CA Muni Income	California	42.1
Phoenix CA TxEx Bond	California	70.3
Pioneer AMT Free CA Muni	California	109.6
Price CA TxFr Bond	California	312.6
Putnam CA TxEx Income	California	2,010.8
RVS CA TxEx	California	173.3
SCBF CA Muni	California	1,366.3
SCBF Short Duratn CA Muni	California	81.3
SEI STET CA Muni	California	209.6
Schwab CA Long Term TxFr	California	219.1
Schwab CA Short Intrmd TxFr Bd	California	98.1

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total assets ($MM)
Schwab CA TxFr YieldPlus	California	1,126.2
Seligman TxEx CA Hi Yield	California	34.7
Seligman TxEx CA Quality	California	41.7
Thornburg Ltd Term CA	California	114.3
USAA TxEx CA Bond	California	724.5
VK Value Muni Inc Tr CA	California	556.2
Van Kampen CA Insured TxFr	California	230.0
Vanguard CA Intrmd TxEx	California	4,001.1
Vanguard CA Long TxEx	California	2,900.3
Wells Fgo Avtg CA Ltd TxFr	California	70.7
Wells Fgo Avtg CA TxFr Bond	California	487.8
Colorado Bond Shares	Colorado	529.5
Delaware Inv CO Insrd Muni Inc	Colorado	105.1
Delaware TxFr CO	Colorado	273.3
Eaton Vance CO Muni	Colorado	45.2
First Am CO Intrmd TxFr	Colorado	41.5
First Am CO TxFr	Colorado	25.7
First Inv Multi Ins TxEx CO	Colorado	9.1
Franklin CO TxFr Income	Colorado	486.0
Nuveen CO Muni Bd	Colorado	44.0
Seligman TxEx CO	Colorado	31.7
Tax Free Fund Of Colorado	Colorado	207.9
Wells Fgo Avtg CO TxFr	Colorado	91.9
Westcore CO TxEx	Colorado	58.0
Columbia CT Intrmd Muni Bond	Connecticut	170.9
Columbia CT Tax Exempt	Connecticut	115.2

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Fund Assets ($Mil)
Dreyfus Premr CT Bond	Connecticut	409.2
Eaton Vance CT Muni	Connecticut	136.5
Evergreen CT Muni	Connecticut	65.3
Fidelity CT Municipal Income	Connecticut	444.9
First Inv Multi Ins TxEx CT	Connecticut	37.9
Franklin CT TxFr Income	Connecticut	359.9
Lord Abbett TxFr CT Income	Connecticut	126.5
Nuveen CT Dvdnd Advtg Muni	Connecticut	57.7
Nuveen CT Dvdnd Advtg Muni 2	Connecticut	52.1
Nuveen CT Dvdnd Advtg Muni 3	Connecticut	94.7
Nuveen CT Municipal Bond	Connecticut	305.8
Nuveen CT Prem Inc Muni	Connecticut	115.9
BlackRock DE Muni	Delaware	59.3
AB Muni Income II FL	Florida	198.0
Am Cent FL Municipal Bond	Florida	35.4
BlackRock FL Ins Muni 2008	Florida	213.1
BlackRock FL Ins Muni Inc	Florida	207.3
BlackRock FL Invest Qual Muni	Florida	24.1
BlackRock FL Muni 2020 Trm	Florida	132.4
BlackRock FL Muni Bd Port	Florida	82.4
BlackRock FL Muni Bond	Florida	112.7
BlackRock FL Muni Inc	Florida	160.2
Delaware Inv FL Insrd Muni Inc	Florida	51.1
Delaware TxFr FL Insured	Florida	89.8
Dreyfus FL Intrmd Muni Bond	Florida	159.9
Dreyfus Premr FL Bond	Florida	81.5

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Eaton Vance FL Insured Muni	Florida	40.8
Eaton Vance FL Ltd Muni	Florida	44.6
Eaton Vance FL Muni	Florida	253.8
Eaton Vance FL Muni Inc Trust	Florida	101.4
Eaton Vance Ins FL Muni Bond	Florida	61.4
Fidelity FL Municipal Income	Florida	412.8
First Inv Multi Ins TxEx FL	Florida	28.6
Franklin FL Insured TxFr Inc	Florida	160.7
Franklin FL TxFr Income	Florida	1,615.3
Lord Abbett TxFr FL	Florida	65.8
MFS Muni FL	Florida	72.1
ML FL Muni Holdings	Florida	647.9
MuniYield FL	Florida	255.1
MuniYield FL Insured	Florida	182.9
Nuveen FL Investment Qual Muni	Florida	382.2
Nuveen FL Muni Bd	Florida	284.7
Nuveen FL Quality Income Muni	Florida	335.3
Nuveen Insrd FL Premium Inc	Florida	331.9
Nuveen Insrd FL TxFr Advtg	Florida	85.2
SIT FL Tax Free Income	Florida	3.1
STI Classic Hi Grade Muni Bond	Florida	170.4
Seligman TxEx FL	Florida	26.8
USAA TxFr FL Income	Florida	226.5
VK Investment Grade FL Muni	Florida	298.7
Vanguard FL Long TxEx	Florida	1,140.1
Columbia GA Intrmd Muni	Georgia	119.8
Eaton Vance GA Muni	Georgia	80.7

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Evergreen GA Muni	Georgia	161.0
First Inv Multi Ins TxEx GA	Georgia	11.7
Franklin GA TxFr Income	Georgia	285.7
Lord Abbett TxFr GA	Georgia	134.0
MFS Muni GA	Georgia	58.2
Nuveen GA Dvdnd Advtg Muni	Georgia	44.0
Nuveen GA Dvdnd Advtg Muni 2	Georgia	99.1
Nuveen GA Muni Bd	Georgia	218.9
Nuveen GA Prem Inc Muni	Georgia	83.5
Price GA TxFr Bond	Georgia	130.8
STI Classic GA TxEx Bond	Georgia	153.9
Seligman TxEx GA	Georgia	27.8
Sentinel GA Municipal Bond	Georgia	39.8
1st Pac Hawaii Intrmd Muni	Hawaii	9.0
1st Pac Hawaii Muni Bond	Hawaii	152.8
Bishop St HI Muni Bond	Hawaii	171.6
Eaton Vance HI Muni	Hawaii	19.6
Hawaiian TxFr Trust	Hawaii	699.6
Lord Abbett TxFr HI Income	Hawaii	98.4
Delaware TxFr ID	Idaho	84.5
ID TxEx	Idaho	9.3
Amer Indep KS TxEx Bond	Kansas	167.9
Commerce KS TxFr Intrmd	Kansas	67.4
Eaton Vance KS Muni	Kansas	32.3
KS Insured Intermediate	Kansas	10.6

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
KS Municipal	Kansas	54.5
Nuveen KS Muni Bd	Kansas	128.4
BB&T KY Intrmd TxFr	Kentucky	13.9
BlackRock KY Muni	Kentucky	126.1
Churchill TxFr Kentucky	Kentucky	264.1
Dupree KY Short/Medium Inc	Kentucky	62.2
Dupree KY TxFr Income	Kentucky	703.1
Eaton Vance KY Muni	Kentucky	62.1
Franklin KY TxFr Income	Kentucky	151.2
JPMorgan KY Muni Bond	Kentucky	89.1
Nuveen KY Muni Bd	Kentucky	455.3
Capital One LA Muni Inc	Lousiana	52.2
Eaton Vance LA Muni	Lousiana	40.2
Franklin LA TxFr Income	Lousiana	262.0
JPMorgan LA Muni Bond	Lousiana	76.1
Nuveen LA Muni Bd	Lousiana	92.4
Seligman TxEx LA	Lousiana	28.7
ME Municipal	Maine	16.6
BB&T MD Intrmd TxFr	Maryland	11.6
BlackRock MD Muni Bond	Maryland	49.8
Brown Advisory MD Bond	Maryland	92.0
Columbia MD Intrmd Muni	Maryland	169.3
Dreyfus Premr MD Bond	Maryland	209.4
Eaton Vance MD Muni	Maryland	91.6

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Evergreen MD Muni Bond	Maryland	67.4
Fidelity MD Municipal Income	Maryland	125.6
First Inv Multi Ins TxEx MD	Maryland	22.8
Franklin MD TxFr Income	Maryland	499.8
Legg Mason MD TxFr	Maryland	150.1
MD TxEx Bond	Maryland	295.8
MFS Muni MD	Maryland	131.9
MTB MD Municipal Bond	Maryland	144.6
Mercantile MD TxEx Bond	Maryland	49.8
Nuveen MD Dvdnd Advtg Muni	Maryland	93.6
Nuveen MD Dvdnd Advtg Muni 2	Maryland	94.4
Nuveen MD Dvdnd Advtg Muni 3	Maryland	117.1
Nuveen MD Muni Bond	Maryland	146.4
Nuveen MD Prem Inc Muni	Maryland	235.1
Price MD TxFr Bond	Maryland	1,469.7
Price MD TxFr Short Bond	Maryland	145.8
Rochester MD Muni	Maryland	17.5
STI Classic MD Muni	Maryland	37.1
Seligman TxEx MD	Maryland	35.1
AB Muni Income II MA	Massachusetts	139.8
Columbia MA Intrmd Muni Bond	Massachusetts	307.3
Columbia MA Tax Exempt	Massachusetts	162.3
DWS MA TxFr Muni	Massachusetts	434.7
Dreyfus Mellon MA Intrmd Muni	Massachusetts	341.3
Dreyfus Premr MA Bond	Massachusetts	244.0
Eaton Vance Ins MA Muni Bond	Massachusetts	42.1
Eaton Vance MA Ltd Muni	Massachusetts	63.2

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Eaton Vance MA Muni	Massachusetts	317.8
Eaton Vance MA Muni Inc Trust	Massachusetts	64.0
Fidelity MA Municipal Income	Massachusetts	1,870.5
First Inv Multi Ins TxEx MA	Massachusetts	26.1
Franklin MA Insrd TxFr Inc	Massachusetts	531.8
J Hancock MA TxFr Income	Massachusetts	105.8
Legg Mason P Muni Bond MA	Massachusetts	95.0
Loomis Sayles MA TxFr Income	Massachusetts	68.3
MA Health & Education TxEx Tr	Massachusetts	42.1
MFS Muni MA	Massachusetts	218.1
Nuveen Insrd MA TxFr Advtg	Massachusetts	60.3
Nuveen MA Dvdnd Advtg Muni	Massachusetts	44.3
Nuveen MA Insured Muni Bond	Massachusetts	79.4
Nuveen MA Muni Bond	Massachusetts	172.5
Nuveen MA Prem Inc Muni	Massachusetts	103.8
Putnam MA TxEx Income	Massachusetts	288.1
RVS MA TxEx	Massachusetts	50.6
Rochester MA Muni	Massachusetts	26.0
SEI STET MA Muni	Massachusetts	39.9
Seligman TxEx MA	Massachusetts	62.3
VK Value Muni Inc Tr MA	Massachusetts	66.6
Vanguard MA TxEx	Massachusetts	648.3
AB Muni Income II MI	Michigan	125.9
Allegiant MI Intrmd Muni Bond	Michigan	56.7
Dreyfus Premr MI Bond	Michigan	96.5
Eaton Vance Ins MI Muni Bond	Michigan	36.6
Eaton Vance MI Muni	Michigan	67.0

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Eaton Vance MI Muni Inc Trust	Michigan	49.2
Federated MI Interm Muni	Michigan	157.9
Fidelity MI Municipal Income	Michigan	581.5
Fifth Third MI Muni Bond	Michigan	49.8
First Inv Multi Ins TxEx MI	Michigan	30.7
Franklin MI Insrd TxFr Income	Michigan	1,442.0
Huntington MI TxFr Bond	Michigan	20.4
JPMorgan MI Muni Bond	Michigan	291.3
Lord Abbett TxFr MI Income	Michigan	71.3
MuniYield MI Insured	Michigan	325.1
MuniYield MI Insured II	Michigan	226.9
Nuveen MI Dvdnd Advtg Muni	Michigan	47.0
Nuveen MI Muni Bd	Michigan	232.4
Nuveen MI Prem Inc Muni	Michigan	171.7
Nuveen MI Quality Income Muni	Michigan	272.8
Putnam MI TxEx Income II	Michigan	110.8
RVS MI TxEx	Michigan	43.3
Rochester MI Muni	Michigan	24.3
Seligman TxEx MI	Michigan	86.3
AB Muni Income II MN	Minnesota	93.6
Delaware Inv MN Muni Income 2	Minnesota	218.2
Delaware MN High Yield Muni	Minnesota	147.1
Delaware TxFr MN	Minnesota	631.4
Delaware TxFr MN Intrmd	Minnesota	55.2
Dreyfus Premr MN Bond	Minnesota	118.2
Eaton Vance MN Muni	Minnesota	68.4
Fidelity MN Municipal Income	Minnesota	340.0

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
First Am MN Intrmd TxFr	Minnesota	192.8
First Am MN TxFr	Minnesota	178.2
First Inv Multi Ins TxEx MN	Minnesota	16.6
Franklin MN Insrd TxFr Income	Minnesota	605.9
Hartford TxFr MN	Minnesota	37.2
Lord Abbett TxFr MN Income	Minnesota	55.2
MN Muni Income Portfolio	Minnesota	61.7
MN Muni Income Portfolio II	Minnesota	21.9
Putnam MN TxEx Income II	Minnesota	105.4
RVS MN TxEx	Minnesota	329.1
Rochester MN Municipal	Minnesota	10.4
SIT MN TxFr Income	Minnesota	293.1
Seligman TxEx MN	Minnesota	74.0
Wells Fgo Avtg MN TxFr	Minnesota	167.3
Dupree MS TxFr Income	Mississippi	5.4
Eaton Vance MS Muni	Mississippi	18.5
MFS Muni MS	Mississippi	84.3
Commerce MO TxFr Intrmd	Missouri	151.4
Eaton Vance MO Muni	Missouri	96.2
First Am MO TxFr	Missouri	157.1
First Inv Multi Ins TxEx MO	Missouri	15.6
Franklin MO TxFr Income	Missouri	697.0
Lord Abbett TxFr MO	Missouri	159.8
Nuveen MO Muni Bd	Missouri	258.7
Nuveen MO Prem Inc Muni	Missouri	49.1
Seligman TxEx MO	Missouri	27.8

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
MT Tax Free	Montana	22.1
Viking MT TxFr	Montana	9.8
First Am NE TxFr	Nebraska	41.8
First Focus NE TxFr	Nebraska	42.9
NE Municipal	Nebraska	28.6
Weitz NE Tax Free Income	Nebraska	49.0
Wells Fgo Avtg NE TxFr	Nebraska	37.4
NH Municipal	N.H.	4.2
AB Muni Income II NJ	New Jersey	156.2
BlackRock NJ Invest Qual Muni	New Jersey	21.7
BlackRock NJ Muni Bd Port	New Jersey	57.3
BlackRock NJ Muni Bond	New Jersey	295.8
BlackRock NJ Muni Inc	New Jersey	183.2
Columbia NJ Intrmd Muni Bond	New Jersey	63.9
Dreyfus NJ Intrmd Muni Bond	New Jersey	171.1
Dreyfus Premr NJ Muni Bond	New Jersey	457.8
Eaton Vance Ins NJ Muni Bond	New Jersey	63.0
Eaton Vance NJ Ltd Muni	New Jersey	38.8
Eaton Vance NJ Muni	New Jersey	335.2
Eaton Vance NJ Muni Inc Trust	New Jersey	110.8
Evergreen NJ Muni Bond	New Jersey	231.8
Fidelity NJ Municipal Income	New Jersey	599.3
First Inv Multi Ins TxEx NJ	New Jersey	57.6
Franklin NJ TxFr Income	New Jersey	1,280.5
Glenmede NJ Muni	New Jersey	15.7

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Legg Mason P Muni Bond NJ	New Jersey	228.8
Lord Abbett TxFr NJ Income	New Jersey	130.5
ML NJ Muni Holdings Insrd	New Jersey	386.1
MuniYield NJ	New Jersey	278.8
MuniYield NJ Insured	New Jersey	188.6
Nuveen NJ Dvdnd Advtg Muni	New Jersey	146.6
Nuveen NJ Dvdnd Advtg Muni 2	New Jersey	103.3
Nuveen NJ Investment Qual Muni	New Jersey	466.7
Nuveen NJ Municipal Bond	New Jersey	193.4
Nuveen NJ Premium Income Muni	New Jersey	274.1
Oppenheimer NJ Municipal	New Jersey	877.1
Price NJ TxFr Bond	New Jersey	217.8
Putnam NJ TxEx Income	New Jersey	197.6
SEI STET NJ Muni	New Jersey	108.3
Seligman TxEx NJ	New Jersey	35.5
VK Investment Grade NJ Muni	New Jersey	170.7
Vanguard NJ Long TxEx	New Jersey	1,792.0
Nuveen NM Muni Bd	New Mexico	60.7
Thornburg Intrmd NM	New Mexico	186.5
AB Muni Income Muni NY	New York	480.0
Alliance NY Muni Income	New York	118.0
BNY Hamilton Intrmd NY TxEx	New York	115.3
BlackRock NY Ins Muni 2008	New York	282.0
BlackRock NY ins Muni Inc	New York	153.7
BlackRock NY Invest Qual Muni	New York	29.1
BlackRock NY Muni 2018	New York	90.0

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total assets ($M)
BlackRock NY Muni Bd	New York	282.1
BlackRock NY Muni Bond	New York	67.5
BlackRock NY Muni Inc	New York	306.1
BlackRock NY Muni Inc II	New York	120.7
Columbia NY Intrmd Muni Bond	New York	145.7
Columbia NY Tax Exempt	New York	82.5
DWS NY TxFr Income	New York	373.5
Delaware TxFr NY	New York	19.1
Dreyfus General NY Muni Bond	New York	246.0
Dreyfus NY TxEx Bond	New York	1,239.0
Dreyfus NY TxEx Intrmd Bond	New York	271.4
Dreyfus Premr NY Muni Bond	New York	156.8
Eaton Vance Ins NY Muni Bd II	New York	62.0
Eaton Vance Ins NY Muni Bond	New York	378.7
Eaton Vance NY Ltd Muni	New York	96.2
Eaton Vance NY Muni	New York	453.8
Eaton Vance NY Muni Inc Trust	New York	130.8
Empire Builder Tx Fr Bond	New York	92.7
Evergreen NY Muni Bond	New York	82.2
Excelsior NY Intrmd TxEx	New York	142.4
Federated NY Muni Income	New York	57.6
Fidelity NY Municipal Income	New York	1,478.3
First Investors NY Ins TxFr	New York	159.3
Franklin NY Insrd TxFr Income	New York	479.8
Franklin NY Intrmd TxFr Income	New York	267.5
Franklin NY Ltd Trm TxFr Inc	New York	6.7
Franklin NY TxFr Income	New York	4,922.6
GS NY Intrmd AMT Free Muni	New York	24.1

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
HSBC Inv NY TxFr Bond	New York	63.7
Hartford TxFr NY	New York	16.4
J Hancock NY TxFr Income	New York	56.3
JPMorgan NY TxFr Bond	New York	625.4
Legg Mason P Intrmd NY Muni	New York	103.8
Legg Mason P Muni Bond NY	New York	747.4
Limited Term NY Muni	New York	4,097.2
Lord Abbett TxFr NY Income	New York	263.0
MFS Muni NY	New York	159.5
ML Muni NY Intermediate	New York	93.7
ML NY Muni Holdings Insrd	New York	551.0
MSDW NY Quality Muni Sec	New York	85.4
MTB NY Municipal Bond	New York	104.9
Morgan Stanley NY TxFr	New York	88.2
MuniYield NY Insured	New York	640.9
NB NY Intermediate Muni	New York	128.7
Nuveen Insrd NY Dvdnd Advtg	New York	181.4
Nuveen Insrd NY Premium Inc	New York	190.4
Nuveen Insrd NY TxFr Advtg	New York	78.8
Nuveen NY Dvdnd Advtg Muni	New York	209.5
Nuveen NY Dvdnd Advtg Muni 2	New York	144.3
Nuveen NY Insured Muni Bond	New York	302.8
Nuveen NY Investment Qual Muni	New York	408.1
Nuveen NY Muni Value	New York	151.1
Nuveen NY Municipal Bond	New York	392.6
Nuveen NY Performance Plus	New York	360.6
Nuveen NY Quality Income Muni	New York	556.7
Nuveen NY Select Qual Muni	New York	548.3

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($Mil)
Nuveen NY Select TxFr Income	New York	55.5
Oppenheimer AMT Free NY Muni	New York	1,468.3
PIMCO NY Muni Income	New York	164.8
PIMCO NY Muni Income II	New York	246.2
PIMCO NY Muni Income III	New York	129.9
PIMCO NY Municipal Bond	New York	68.3
Price NY TxFr Bond	New York	276.3
Putnam NY Inv Grade Muni	New York	37.5
Putnam NY TxEx Income	New York	1,122.5
RVS NY TxEx	New York	67.1
Rochester Fund Muni	New York	11,218.1
SCBF NY Muni	New York	1,711.3
SCBF Short Duratn NY Muni	New York	104.3
SEI STET NY Muni	New York	142.6
Seligman TxEx NY	New York	67.4
Thornburg Intrmd NY	New York	33.8
USAA TxEx NY Bond	New York	159.5
VK Investment Grade NY Muni	New York	399.6
Value Line TxEx NY	New York	22.5
Van Kampen NY TxFr Income	New York	127.9
Vanguard NY Long TxEx	New York	2,621.2
BB&T NC Intrmd TxFr	N.C.	113.1
Columbia NC Intrmd Muni	N.C.	187.0
Dreyfus Premr NC Bond	N.C.	66.7
Dupree NC Short/Medium Inc	N.C.	11.3
Dupree NC TxFr Income	N.C.	54.6
Eaton Vance NC Muni	N.C.	91.2

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Fund Assets ($Mil)
Evergreen NC Muni	N.C.	560.0
Federated NC Muni Income	N.C.	45.8
First Inv Multi Ins TxEx NC	N.C.	25.6
Franklin NC TxFr Income	N.C.	773.9
MFS Muni NC	N.C.	323.9
Nuveen NC Dvdnd Advtg Muni	N.C.	50.6
Nuveen NC Dvdnd Advtg Muni 2	N.C.	83.7
Nuveen NC Dvdnd Advtg Muni 3	N.C.	84.9
Nuveen NC Muni Bd	N.C.	320.6
Nuveen NC Prem Inc Muni	N.C.	138.7
Rochester NC Muni	N.C.	20.7
STI Classic NC TxEx Bond	N.C.	44.3
Seligman TxEx NC	N.C.	16.5
ND Tax Free	North Dakota	15.0
Viking ND TxFr	North Dakota	5.7
AB Muni Income II OH	Ohio	165.7
Allegiant OH Intrmd TxEx Bond	Ohio	136.8
BlackRock OH Muni	Ohio	107.0
Dreyfus Premr OH Bond	Ohio	204.1
Eaton Vance Ins OH Muni Bond	Ohio	60.2
Eaton Vance OH Ltd Muni	Ohio	19.6
Eaton Vance OH Muni	Ohio	313.6
Eaton Vance OH Muni Inc Trust	Ohio	66.6
Federated OH Muni Income	Ohio	124.9
Fidelity OH Municipal Income	Ohio	422.9
Fifth Third OH Muni Bd	Ohio	107.8

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
First Am OH TxFr	Ohio	42.9
First Inv Multi Ins TxEx OH	Ohio	24.2
Franklin OH Insrd TxFr Income	Ohio	1,188.1
Huntington OH Tax Free	Ohio	41.0
JPMorgan OH Muni Bond	Ohio	207.6
Nuveen OH Dvdnd Advtg Muni	Ohio	95.1
Nuveen OH Dvdnd Advtg Muni 2	Ohio	70.5
Nuveen OH Dvdnd Advtg Muni 3	Ohio	49.2
Nuveen OH Muni Bd	Ohio	536.4
Nuveen OH Quality Income Muni	Ohio	233.7
Putnam OH TxEx Income II	Ohio	153.9
RVS OH TxEx	Ohio	44.1
Rochester OH Muni	Ohio	38.2
Seligman TxEx OH	Ohio	96.9
Touchstone OH Insured TxFr	Ohio	63.1
VK OH Quality Muni	Ohio	145.8
Vanguard OH Long Tax Exempt	Ohio	658.7
Victory OH Muni Bond	Ohio	110.1
OK Municipal	Oklahoma	50.9
Columbia OR Intrmd Muni Bond	Oregon	383.4
Eaton Vance OR Muni	Oregon	129.7
First Am OR Intrmd TxFr	Oregon	119.8
First Inv Multi Ins TxEx OR	Oregon	34.7
Franklin OR TxFr Income	Oregon	793.4
Legg Mason P Muni Bond OR	Oregon	68.6
Seligman TxEx OR	Oregon	49.0

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State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
Tax Free Trust Of Oregon	Oregon	421.1
AB Muni Income II PA	Pennsylvania	147.2
Allegiant PA Intrmd Muni Bond	Pennsylvania	39.9
BlackRock PA Muni Bond	Pennsylvania	585.0
BlackRock PA Strategic Muni Tr	Pennsylvania	47.3
Delaware TxFr PA	Pennsylvania	558.9
Dreyfus Mellon PA Intrmd Muni	Pennsylvania	608.9
Dreyfus PA Intrmd Muni Bond	Pennsylvania	70.2
Dreyfus Premr PA Bond	Pennsylvania	159.4
Eaton Vance Ins PA Muni Bond	Pennsylvania	72.3
Eaton Vance PA Ltd Muni	Pennsylvania	51.0
Eaton Vance PA Muni	Pennsylvania	293.7
Eaton Vance PA Muni Inc Trust	Pennsylvania	63.8
Evergreen PA Muni	Pennsylvania	788.9
Federated PA Muni Income	Pennsylvania	331.9
Fidelity PA Municipal Income	Pennsylvania	301.8
First Inv Multi Ins TxEx PA	Pennsylvania	45.0
Franklin PA TxFr Income	Pennsylvania	899.0
Legg Mason P Muni Bond PA	Pennsylvania	122.7
Lord Abbett TxFr PA	Pennsylvania	95.3
MFS Muni PA	Pennsylvania	107.8
MTB PA Municipal Bond	Pennsylvania	138.4
MuniYield PA Insured	Pennsylvania	220.3
Nuveen PA Dvdnd Advtg Muni	Pennsylvania	75.9
Nuveen PA Dvdnd Advtg Muni 2	Pennsylvania	85.3
Nuveen PA Investment Qual Muni	Pennsylvania	378.4
Nuveen PA Muni Bd	Pennsylvania	210.9

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Firm	State	Total assets ($MM)
Nuveen PA Prem Inc2 Muni	Pennsylvania	349.6
Oppenheimer PA Municipal	Pennsylvania	1,348.3
Putnam PA TxEx Income	Pennsylvania	163.3
SEI STET PA Muni	Pennsylvania	105.2
Seligman TxEx PA	Pennsylvania	15.9
VK Value Muni Inc Tr PA	Pennsylvania	603.3
Van Kampen PA TxFr Income	Pennsylvania	182.3
Vanguard PA Long TxEx	Pennsylvania	2,438.0
Franklin Double TxFr Income	Puerto Rico	516.4
Columbia RI Intrmd Muni Bond	Rhode Island	116.7
Eaton Vance RI Muni	Rhode Island	64.5
Narragansett Ins TxFr Inc	Rhode Island	152.4
Ocean State TxEx	Rhode Island	23.3
BB&T SC Intrmd TxFr	S.C.	17.4
Columbia SC Intrmd Muni	S.C.	183.1
Eaton Vance SC Muni	S.C.	128.8
Evergreen SC Muni	S.C.	318.7
MFS Muni SC	S.C.	154.1
Seligman TxEx SC	S.C.	71.2
Dupree TN Short/Medium Income	Tennessee	11.0
Dupree TN TxFr Income	Tennessee	99.4
Eaton Vance TN Muni	Tennessee	58.0
Franklin TN Muni Bond	Tennessee	167.2
GS TN Muni	Tennessee	81.9

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total Assets ($MM)
MFS Muni TN	Tennessee	109.8
Nuveen TN Muni Bd	Tennessee	331.4
Lord Abbett TxFr TX Income	Texas	72.7
Nuveen TX Quality Income Muni	Texas	212.4
Tax Free Fund For Utah	Utah	228.4
Calvert TxFr Reserves VT	Vermont	48.1
Federated VT Muni Income	Vermont	28.4
AB Muni Income II VA	Virginia	178.0
BB&T VA Intrmd TxFr	Virginia	76.9
BlackRock VA Muni Bond Trust	Virginia	38.4
Columbia VA Intrmd Muni	Virginia	323.9
Dreyfus Premr VA Bond	Virginia	63.7
Eaton Vance VA Muni	Virginia	128.5
Evergreen VA Muni	Virginia	223.4
First Inv Multi Ins TxEx VA	Virginia	33.0
Franklin VA TxFr Income	Virginia	556.8
Jamestown TxEx VA	Virginia	28.9
MFS Muni VA	Virginia	290.5
MTB VA Municipal Bond	Virginia	17.9
Madison Mosaic TxFr VA	Virginia	25.1
Nuveen VA Dvdnd Advtg Muni	Virginia	71.3
Nuveen VA Dvdnd Advtg Muni 2	Virginia	129.1
Nuveen VA Muni Bd	Virginia	326.5
Nuveen VA Prem Inc Muni	Virginia	197.9

State-Specific Municipal Bond Funds, By State
(Open-End and Closed-End Funds, as of May 31, 2007)

Fund	State	Total assets ($MM)
Price VA TxFr Bond	Virginia	550.7
Rochester VA Muni	Virginia	15.8
STI Classic VA Intrmd Muni	Virginia	217.9
USAA TxEx VA Bond	Virginia	547.4
VA TxEx Bond	Virginia	308.4
Lord Abbett TxFr WA Income	Washington	41.7
BB&T WV Intrmd TxFr	West Virginia	70.0
Eaton Vance WV Muni	West Virginia	32.1
JPMorgan WV Muni Bond	West Virginia	95.0
MFS Muni WV	West Virginia	137.7
Wesmark WV Muni Bond	West Virginia	68.8
North Track WI TxEx	Wisconsin	164.6
Nuveen WI Muni Bd	Wisconsin	51.7
Wells Fgo Avtg WI TxFr	Wisconsin	71.3
Total		$192,170.2 (MM)

Source: Avi Nachmany, Director of Research, Strategic Insight Mutual Fund Research and Consulting

APPENDIX B

Letter from Mrs. Barbara Gower, Louisville, Ky.

[Fold-out Exhibit, next page]

I was a child in the 30's grew up in the 40's right here in Louisville. I have several recurring memories, one of these is our highway system, narrow, winding 2 lane roads, dark at night.

These roads were important to our family as our main if not only recreation was to drive to visit relatives in Hopkinsville Ky, Evansville Ind and Columbus Ohio. All of [illegible] trips required use of Ky roads.

My parents were on the way to Hopkinsville after dark when they rounded a curve

to find a cow in the middle of the road. Daddy swerved, missing the cow but overturning the car.

Neither of my parents were hurt but the Model a Ford required some fixing.

Hooray for Kentucky Turnpikes

Barbara Gower
Louisville, Kentucky
Shareholder since 1997

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No. 06-666

Supreme Court, U.S.
FILED
JUL 19 2007
OFFICE OF THE CLERK

In the Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

v.

GEORGE W. DAVIS and
CATHERINE V. DAVIS,
Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF FOR DUPREE MUTUAL FUNDS AS *AMICUS CURIAE* SUPPORTING PETITIONERS

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July 19, 2007

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

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Linda M. Beale, *Point & Counter Point: The Constitutionality of Tax Exemptions for Home State Bonds Under the Dormant Commerce Clause*, Wayne State University Law School Legal Studies Research Paper Series, No. 07-12, (Apr. 1, 2007) *available at* http://www.ssrn.com/link/Wayne-State-U-LEG.html 7

BRIEF OF *AMICUS CURIAE* DUPREE MUTUAL FUNDS

IDENTITY AND INTEREST OF *AMICUS CURIAE*

Dupree Mutual Funds ("Dupree") respectfully submits its brief as *amicus curiae* in support of Petitioners Department of Revenue of the Commonwealth of Kentucky and Finance and Administration Cabinet of the Commonwealth of Kentucky, pursuant to Supreme Court Rule 37.3.[1] Dupree is organized as a business trust under the laws of the Commonwealth of Kentucky and is registered as an investment company under the Investment Company Act of 1940. Dupree is a no-load mutual fund based in Lexington, Kentucky that offers shares in separate investment series to the public.

Dupree operates eight single-state open-end municipal bond funds in Kentucky, Tennessee, Alabama, Mississippi, and North Carolina: the Kentucky Tax-Free Income Series; Kentucky Tax-Free Short-to-Medium Series; Tennessee Tax-Free Income Series; Tennessee Tax-Free Short-to-Medium Series; Alabama Tax-Free Income Series; Mississippi Tax-Free Income Series; North Carolina Tax-Free Income Series; and the North Carolina Tax-Free Short-to-Medium Series. Dupree's flagship fund, the Kentucky Tax-Free Income Series, is the largest single-state municipal bond fund in the Commonwealth of Kentucky, has been in existence since 1979, and currently has net assets in excess of $700 million.

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[1] Pursuant to 37.6, Dupree affirms that no counsel for any party authored this brief in whole or in part and that no person or entity, other than Dupree, made any monetary contribution to the preparation or submission of this brief. This brief is filed by Dupree pursuant to the consent of all parties.

Dupree's single-state funds are marketed primarily to residents of their respective states in order for investors to obtain the advantage of tax exemptions in their home states comparable to Kentucky's tax exemption for interest earned on municipal bonds issued within the Commonwealth of Kentucky. Dupree is one of the largest purchasers of municipal bonds issued in the Commonwealth of Kentucky. Dupree purchases bonds issued by municipalities, counties, local school boards, and similar entities, and it holds those bonds on behalf of its shareholders. Currently, Dupree has approximately 10,500 shareholders, of which approximately 7,000 are Kentucky residents.

SUMMARY OF ARGUMENT

Kentucky's tax exemption of interest earned on municipal bonds does not violate the dormant Commerce Clause. Kentucky's tax legislation supports its legitimate government purpose and sovereign interest in financing public projects for the benefit of its citizens. Kentucky passed its tax exemption regulations in order to encourage its citizens to invest in their State rather than subsidize the public works of other states. Without the exemption, the borrowing costs of Kentucky and its municipalities would increase substantially, impacting the State's ability to finance public projects. Any ruling that Kentucky's tax-exemption regulations in this context are unconstitutional would result in unprecedented judicial interference with its state sovereignty.

Furthermore, the Commerce Clause was never intended to encompass purely governmental activity. The Court's Commerce Clause jurisprudence consistently has reflected that the dormant Commerce Clause prohibits State interference with the free private market. A State may not use its treasury to advance the economic competitiveness of its in-state,

private industries to the detriment of out-of-state interests. Kentucky's tax exemption for interest earned on municipal bonds, however, does not involve any private market. Municipal bonds by definition are entirely creatures of State governments and their political subdivisions. The only "competition" is from other States' municipal bonds. The market at issue, therefore, is purely public and does not involve free private trade. The Commerce Clause does not extend to purely public activity.

Finally, Kentucky fits squarely within the "market participant" doctrine, which renders the Commerce Clause inapplicable to its activities. The market at issue is the issuance and promotion of municipal bonds. This market would not exist but for the State's involvement. By definition, private industry does not issue or compete in the issuance of municipal bonds. As no inherent profit motive exists with the financing of public works, private industry never would seek capital for the construction of public projects and does not meet the need which the State and its subdivisions fulfill. As Kentucky is a market participant in the issuance of municipal bonds, it may promote its bonds and create incentives for their purchase through tax exemptions.

ARGUMENT

I. Kentucky's Tax Exemption Supports the State's Sovereign Interest in Financing Its Public Works.

Under this Court's jurisprudence, state legislation that discriminates against interstate commerce may be constitutionally permissible if it is unrelated to economic protectionism and advances a legitimate government purpose. *See United Haulers Assoc., Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 127 S. Ct. 1786, 1795-96

(2007); *Maine v. Taylor*, 477 U.S. 131, (1986). If the statute serves a legitimate local interest and its purpose "cannot be served as well by available nondiscriminatory means," then the statute is not violative of the dormant Commerce Clause. *Taylor*, 477 U.S. at 140. Moreover, where the legislation actually favors state and local government itself, in contrast to promoting private economic interests, the Court's precedent indicates that a lesser showing than other "available nondiscriminatory means" is required.

In *United Haulers*, the Court held that the rigorous scrutiny of laws which fostered economic protectionism was not appropriate for laws favoring local government. 127 S. Ct. at 1795-96. As the Court noted, States and municipalities are not private businesses. *Id.* at 1795. "Unlike private enterprise, government is vested with the responsibility of protecting the health, safety, and welfare of its citizens." *Id.* (citing *Metropolitan Life Ins. Co. of Massachusetts*, 471 U.S. 724, 756 (1985) ("The States traditionally have had great latitude under their police powers to legislate as to the protection of lives, limbs, health, comfort, and quiet of all persons.")). State and local governments thus enact laws to implement innumerable legitimate goals unrelated to economic protectionism. *Id.* at 1796. When the State or local government regulation at issue furthers a typical or traditional governmental function, the courts should be particularly hesitant to interfere with the regulation under the auspices of the Commerce Clause. *Id.* Judicial scrutiny of laws promoting state and local government interests, as the dormant Commerce Clause permits in the area of private market competition, would result in unlimited judicial interference with the States and their ability to perform their traditional functions. *Id.*

In *Bonaparte v. Tax Court*, this Court affirmed more than a century ago the right of a State to tax its citizens for interest earned on municipal bonds issued by another State. 104 U.S. 592 (1881). The case arose when a resident of Baltimore, Maryland claimed an exemption for interest earned on various extraterritorial state and municipal "stocks" on the basis that they were of "public character" and exempt from taxation by the laws of their issuing states. *Id.* at 592. The Maryland tax authority denied her claim for exemption, and she sued to challenge the decision on the theory Maryland's law violated the Full Faith and Credit Clause of the United States Constitution. *Id.*

The *Bonaparte* Court upheld Maryland's authority to tax income earned on other States' municipal bonds, holding that every State has the sovereign right to tax its citizens for interest earned on extraterritorial municipal bonds, or provide an exemption, as the State deems proper. *Id.* at 595. A State may tax its citizens for income earned, regardless of the *situs* of the property or debt giving rise to the income. *Id.* The Court recognized that, even though a citizen of a state may invest in bonds issued by other States, the citizen is still "a resident of the State in which he dwells" and subject to its sovereignty. *Id.* The State has the right to see that each citizen "contribute[s] his just share towards supporting the government whose protection he claims and to whose control he has submitted himself." *Id.* Although the challenge presented to the tax law in *Bonaparte* was based on the Full Faith and Credit Clause, the case is pertinent for its recognition of the States' sovereign right to tax their citizens.

Therefore, if legislation has a rational basis to a legitimate government interest unrelated to economic protectionism, the Court should subject it to mild scrutiny and defer to the State's sovereign interests in effectuating its public purposes

and performing its traditional functions. *See, e.g., United Haulers*, 127 S. Ct. at 1795-96. In the case *sub judice*, Kentucky is not utilizing its tax-exemption provisions in order to shield its in-state industries from out-of-state competition. Instead, Kentucky's purpose is to encourage investment directly in state and local public works, which directly promotes the welfare of its citizens.

The issuance of municipal bonds allows state and local governments to borrow money to finance public projects, such as the construction of schools, bridges, sewage treatment facilities, and highways. Exemption from state taxation for interest earned on in-state municipal bonds provides an incentive for the citizens of the issuing State to invest in the public projects that benefit all citizens within the State. State and local governments realize capital cost reductions through the tax exemption, making municipal bonds an effective means of financing capital projects. *See* Dwight Denison, *et al.*, *Davis v. Department of Revenue of Kentucky: A Preliminary Impact Assessment*, Institute for Federalism & Intergovernmental Relations, IFIR Working Paper No. 2007-03, p.2, *available at* http://www.ifigr.org/publication/ifir_working_papers/IFIR-WP-2007-03.pdf. "The double exemption (from both federal and state income taxes) has enhanced the marketability of muni issues and has acted as a capital subsidy for state and local government entities." *Id.*

If Kentucky no longer could provide the tax exemption, its ability to raise capital to finance its public projects would be seriously impaired as the marketability of bonds of issuers such as small school districts, cities and counties will be greatly diminshed. The State's borrowing costs would increase substantially because it would have to offer a higher return on its bonds, costing the State dollars it otherwise could have allocated to finance capital projects. *See* Linda M.

Beale, *Point & Counter Point: The Constitutionality of Tax Exemptions for Home State Bonds Under the Dormant Commerce Clause*, Wayne State University Law School Legal Studies Research Paper Series, No. 07-12, p.13, *available at* http://www.ssrn.com/link/Wayne-State-U-LEG.html. Otherwise, if Kentucky did not increase the returns on its municipal bonds, its citizens might begin investing in other States' bonds offering higher interest rates and/or backed by higher credit ratings. *Id.*

Even though Kentucky's statutory scheme should be subject only to mild scrutiny, it also passes scrutiny under the stricter standard of no other "available nondiscriminatory means." The abilities of state and local governments otherwise "to incur debt or to finance facilities out of tax revenues" has limits. *C&A Carbone, Inc. v. Town of Clarkstown, New York*, 511 U.S. 383, 428-29 (1994) (Souter, J., dissenting). The State cannot give itself a direct subsidy to finance its public projects, which presumably would have been constitutionally permissible if possible. *See, e.g., West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 198 (1994) ("A pure subsidy funded out of general revenue ordinarily imposes no burden on interstate commerce . . . ."). The only practicable way for Kentucky to make investment in its municipal bonds more attractive is to provide a tax exemption for interest earned on the bonds.

Regardless of whether Kentucky could finance its public works through other means, Kentucky has the right to encourage its citizens to invest in projects that benefit the state in which they dwell. It should be able to provide incentives for its residents to invest in bonds that finance projects in their own state. Without the tax exemption, residents of Kentucky might be encouraged to divert more of their investment money to municipal bonds issued out-of-state, thereby

subsidizing the public projects of other States. Nothing in the Court's dormant Commerce Clause jurisprudence requires Kentucky to subsidize the public works of other States. If the Court were to interpret the Commerce Clause in this manner now, the result would constitute an unprecedented interference with the State's relations with its citizens as their sovereign.

II. Kentucky's Tax Exemption Does Not Violate the Commerce Clause Because the Competition in the Municipal Bond Market Is Between Co-Equal States and Free Private Trade Is Not Involved.

The Commerce Clause was enacted in part to ensure that the States did not unduly burden interstate competition between private individuals and industries by favoring their in-state, private producers and businesses. As Justice Jackson wrote, "Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them." *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 539, 69 S. Ct. 657, 665 (1949). In this vein, the Court in its early Commerce Clause decisions struck down State regulations attempting to restrict the flow of natural resources across state lines, on the basis that States are "without power to prevent privately owned articles of trade from being shipped and sold in interstate commerce on the ground that they are required to satisfy local demands or because they are needed by the people of the State." *Foster-Fountain Packing Co. v. Haydel*, 278 U.S. 1, 10 (1928).

As the Court's jurisprudence developed, the dormant Commerce Clause came to represent the principle that economic protectionism of local production to the detriment

of "the products of another state or the labor of its residents" is contrary to the national framework. *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527, 55 S. Ct. 497, 502 (1935) (Cardozo, J.). Thus, the Court's development and application of dormant Commerce Clause doctrine consistently has been concerned with preventing the States from shielding their in-state private industries from out-of-state competition. *See, e.g., West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 114 S. Ct. 2205, (1994); *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 273-74, 108 S. Ct. 1803, 1807 (1988) (States may not "benefit in-state economic interests by burdening out-of-state competitors."); *Philadelphia v. New Jersey*, 437 U.S. 617, 624, 98 S. Ct. 2531, 2535 (1978); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 269 (1984) (tax exemption for "local industries" producing traditional Hawaiian alcoholic beverages held unconstitutional).

Thus, the dormant Commerce Clause's reach extends only to "state taxes and regulatory measures impeding *free private trade* in the national marketplace." *Reeves, Inc. v. Stake*, 447 U.S. 429, 436-37, 100 S. Ct. 2271, 2277 (1980) (emphasis added). "No State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.'" *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977) (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959)). As States have the potential to exert great influence on markets through their treasuries, the dormant Commerce Clause acts as a check on the States' power to impede the "free flow of private trade in interstate commerce, or . . . to discriminate against such commerce." *White v. Massachusetts Council of Construction Employers, Inc.*, 460 U.S. 204, 221 (1983). Therefore, the scope of the dormant Commerce Clause is to remove any state-imposed barriers to

"free private trade" among the citizens of the several States. The Commerce Clause, however, does not prohibit legislation advancing State creation of a public market or competition therein.

In *Hughes v. Alexandria Scrap Corp.*, this Court held that Maryland's statutory scheme for ridding the state of old automobile hulks by paying bounties to Maryland scrap processors if they presented an "indemnity agreement" from unlicensed hulk suppliers was constitutional, even though out-of-state processors were required to show more extensive documentation. 426 U.S. 794 (1976). Even though Maryland's statutory scheme created an incentive for unlicensed hulk suppliers to use in-state scrap processors, the Court concluded that no trade barrier of the type prohibited by the Commerce Clause impeded the hulks from leaving the state. *Id.* at 809-10. Instead, Maryland had simply enhanced the market for hulks by offering the bounty. *Id.* at 810.

In a concurring opinion, Justice Stevens noted the distinction between a State's participation in the private market and its actual creation of a market:

> It is important to differentiate between commerce which flourishes in a free market and commerce which owes its existence to a state subsidy program. Our cases finding that a state regulation constitutes an impermissible burden on interstate commerce all dealt with restrictions that adversely affected the operation of a free market. This case is unique because the commerce which Maryland has "burdened" is commerce which would not exist if Maryland had not

> decided to subsidize a portion of the automobile scrap-processing business.

Id. at 815.

Justice Stevens continued by recognizing that the State's failure to create commerce could not be objectionable as the Commerce Clause does not impose "any obligation to subsidize out-of-state business." *Id.* at 815-16. Similarly, the State can provide incentives or encouragement to local industry. *Id.* at 816. Under these circumstances, the State's encouragement is not objectionable as a burden on commerce regardless of whether it "takes the form of a cash subsidy, a tax credit, or a special privilege intended to attract investment capital." *Id.*

In contrast to precluding economic protectionism affecting private industry, the Commerce Clause was never intended to regulate "competition" between state governments trying to finance their public works. This Court consistently has interpreted the dormant Commerce Clause as a prohibition against state regulations that impede or discriminate against free, private markets operating in interstate commerce. The basis for the concern is the idea that States, by utilizing their more expansive treasuries *vis-à-vis* private companies or individuals, will provide an unfair competitive advantage for their own citizens at the expense of out-of-state private interests, thereby upsetting the free market.

In the present case, however, the commerce at issue does not involve private industry, or even a combination of private and public industry. Even more so than Maryland's enhancement of the market for scrap-automobile hulks, Kentucky's issuance of municipal bonds creates a market that otherwise would not exist. By definition, only the State or its

municipalities may issue municipal bonds. No private commerce is affected. Therefore, Kentucky's tax exemption does not discriminate against interstate commerce, because no private interstate trade is involved with the issuance of municipal bonds.

The competition here is narrowly limited to municipal bonds issued by other States, i.e., competition between the States' governments themselves. As Justice Stevens' concurring opinion in *Hughes* reflects, the dormant Commerce Clause serves as a check against States providing an unfair advantage to its in-state industries by using its greater treasury to the detriment of out-of-state private competition. Such a concern simply does not exist when the competition is not out-of-state private industry but other States themselves. Whether the State promotes the market it created by tax credit, subsidy, or other "special privilege intended to attract investment capital" is irrelevant. The municipal bond market in Kentucky was created by the State and would not exist otherwise. Kentucky thus chose to promote that market in the only practicable manner available to it, through legislation providing a tax exemption. Kentucky's tax exemption applies only to interest earned on municipal bonds issued by the State. Interest earned by Kentucky residents from investment in municipal bonds issued by other States is subject to regular taxation. Nothing is constitutionally impermissible about Kentucky promoting the market it created.

III. As a "Market Participant," Kentucky May Offer Tax Exemption as an Incentive to Promote Its Municipal Bonds to Its Residents.

When a State engages in "market participation," it is not subject to the restrictions placed on its regulatory authority by

the dormant Commerce Clause. *Wisconsin Dep't of Industry, Labor and Human Relations v. Gould, Inc.*, 475 U.S. 282, 289 (1986). The inquiry thus is limited to whether the challenged state program constitutes direct state participation in the market. *Reeves, Inc. v. Stake*, 447 U.S. 429, 436, n.7 (1980). When engaging in public works projects, a State or municipality acts as a market participant. *See United Building & Construction Trades Council of Camden County and Vicinity v. Mayor and Council of the City of Camden*, 465 U.S. 208 (1984). Acting as a market participant, the State enjoys the same "long recognized right of [any] trader or manufacturer, engaged in an entirely private business, freely to exercise his own independent discretion as to the parties with whom he will deal." *Reeves*, 447 U.S. at 438-39 (quoting *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919)). In other words, the State acting as market participant may favor its own citizens over out-of-state residents in the distribution of benefits resulting from the State's market activities. *Hughes v. Alexandria Scrap Corp.*, 426 U.S. [illegible] 810 (1976). Such activities are not "the kind of action with which the Commerce Clause is concerned." *Id.* at 805.

In *Reeves v. Stake*, the State of South Dakota commenced construction of a cement plant in 1919, in order to address perceived regional shortages and to ensure the State's citizens had access to sufficient quantity of the crucial building material. 447 U.S. at 430. In the years subsequent to initial construction of the facility, it produced more cement than South Dakotans required and, as a result, was selling approximately 40% of its product outside of the State by the 1970s. *Id.* at 431-32. By the time of the 1978 construction season, however, difficulties at the plant slowed production, causing the plant to be unable to fill all its orders. *Id.* at 432. Due to the shortage in production, South Dakota reaffirmed

its initial policy, which had led to the plant's construction in 1919, of allocating its supply to South Dakota customers first in preference to out-of-state buyers. *Id.* Reeves, Inc., a Wisconsin ready-mix concrete distributing company, which had been a customer of the South Dakota plant for 20 years, was forced to cut its production by 76% after the plant denied it further supply. *Id.* at 433.

In considering Reeves' Commerce Clause challenge to South Dakota's actions, the Court recognized that "[t]here is no indication of a constitutional plan to limit the ability of the States themselves to operate freely in the free market." *Id.* at 437. When acting as a "market participant," the State can fairly claim some measure of a sovereign interest in deciding "how, with whom, and for whose benefit to deal." *Id.* at 439, n.10. When a State engages directly in proprietary functions, the Court stated that the judiciary should exhibit some restraint as the competing considerations behind the State's activity will be difficult to assess under traditional Commerce Clause analysis. *Id.* at 439. As a seller of cement, South Dakota unquestionably met the definition of "market participant." *Id.* at 440. The Court further noted that, in undertaking the construction of the cement facility, South Dakota had filled a demand which the free market had failed to supply, without any way of knowing whether private industry ever would move into the market area to fill the State's needs for cement. *Id.* at 446. As a result, South Dakota had the right to ensure that the intended benefit of its foresight, risk and industry went to its citizens. *Id.* The Court, therefore, held that South Dakota's preferential treatment in favor of its citizens did not violate the dormant Commerce Clause.

Similarly, in *White v. Massachusetts Council of Construction Employers*, the Court upheld an executive order

issued by the mayor of Boston which required all construction projects funded, in whole or in part, by city funds to be performed by a work force comprised by at least a half of Boston residents. 460 U.S. 204 (1983). The Court noted that a state or local government is not subject to the constraints of the Commerce Clause once it has entered the market as a participant. *Id.* at 208. As a corollary, the Court further recognized that the inquiry whether any adverse impact on interstate commerce existed was pertinent only if the city was regulating the market rather than participating in it. *Id.* at 210. To the extent that the city expended its own funds to finance public projects, the Court held it was a market participant and could condition the parties with which it would deal. *Id.* at 214-15.

Moreover, as discussed above, when a State effectively creates a market which did not exist previously, it may implement legislation that impacts the competitiveness of out-of-state competition. *Hughes v. Alexandria Scrap*, 426 U.S. 794 (1976). In *Hughes*, Maryland's statutory scheme created an incentive for unlicensed automobile-hulk suppliers to use in-state scrap processors. *Id.* at 809-810. Yet, as Maryland simply had enhanced the market for the hulks by offering a bounty, the Court concluded that the State had not created a trade barrier of the type prohibited by the Commerce Clause. *Id.* at 810.

Kentucky is a participant in the municipal bond market. Its competition is other state governments. The tax exemption Kentucky provides to its residents for interest earned on state and local municipal bonds directly promotes the State's bonds. The exemption makes the State's municipal bonds more attractive to in-state investors than the bonds of other state governments. In essence, Kentucky's tax exemption scheme operates in a manner comparable to a manufacturer's

rebate or coupon. A private manufacturer may offer a cash rebate or coupon as an incentive to a consumer for purchasing the manufacturer's product. The State certainly should be able to offer analogous incentives for its products when acting as a market participant.

Furthermore, Kentucky's purpose in promoting the issuance of, and market for, municipal bonds is to raise capital financing for public projects that otherwise might be unsupportable by the limits of the public fisc. By their inherent nature, such projects do not encompass a private profit motive. Thus, private industry has no incentive to undertake the building of schools, or highways, or bridges. These projects, however, are critical to the citizens of Kentucky. As with South Dakota in *Reeves*, Kentucky has created a market that would not be filled otherwise by private industry. Therefore, Kentucky may properly favor with a tax benefit its citizens who support the State's goal of financing public works. Kentucky's promotion of municipal bonds via its tax exemption regulations is necessary to advance its legitimate marketplace goals.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,
Respondents.

On Writ of Certiorari to the Kentucky Court of Appeals

BRIEF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION, NATIONAL GOVERNORS ASSOCIATION, NATIONAL LEAGUE OF CITIES, NATIONAL CONFERENCE OF STATE LEGISLATURES, NATIONAL ASSOCIATION OF COUNTIES, COUNCIL OF STATE GOVERNMENTS, U.S. CONFERENCE OF MAYORS, INTERNATIONAL MUNICIPAL LAWYERS ASSOCIATION, AND INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION AS *AMICI CURIAE* SUPPORTING PETITIONERS

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QUESTION PRESENTED

Whether Kentucky's income tax exemption for interest on municipal bonds issued by the Commonwealth or its political subdivisions violates the dormant Commerce Clause because Kentucky does not exempt interest earned by Kentucky taxpayers on bonds issued by other States or their political subdivisions.

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INTEREST OF THE *AMICI CURIAE*

Amici are organizations whose members include state, county, and municipal governments and officials throughout the United States.[1] *Amici* have a compelling interest in all legal issues affecting the essential workings of state and local government finance, including the constitutionality of state laws that exempt municipal bond interest from taxation. They accordingly submit this brief to assist the Court in the resolution of this case.

SUMMARY OF ARGUMENT

1. Historical and pragmatic considerations provide compelling reasons to uphold Kentucky's income tax exemption for the interest earned on municipal bonds issued by the Commonwealth and its political subdivisions.

First, since the advent of state personal income taxes in the early 1900s, the States have maintained exemptions similar or identical to Kentucky's that favor in-state municipal bonds. Congress has long been aware of these exemptions and plainly has the authority to regulate the state taxation of interstate commerce. Yet it has never seen fit to prohibit this practice. Where Congress has left undisturbed a longstanding and nearly universal state tax policy, its tacit approval is entitled to substantial respect, as this Court has recognized.

Second, a decision by this Court to invalidate Kentucky's exemption would impose significant economic hardships on the States. Presently, the overwhelming majority of States exempt some or all in-state municipal bond interest from personal income taxation while taxing the interest earned on

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[1] The parties have filed blanket consents to the filing of *amicus* briefs in this case. Pursuant to Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amici*, their members, or their counsel made a monetary contribution to the preparation or submission of this brief.

out-of-state municipal bonds. Prior to the decision below, state governments had no reason to believe that these exemptions might be unconstitutional, and have structured their fiscal affairs accordingly for almost a century. Precisely because so many States and local governments have incurred immense financial obligations based on these understandings, a decision to invalidate Kentucky's tax scheme would drain state treasuries of billions of dollars, transition costs that are manifestly unfair given the States' longstanding and reasonable reliance on the exemptions' constitutionality.

Finally, the principal reason state governments would incur these costs is that this Court's decision might well apply retroactively. States could be forced to refund all recently paid taxes on out-of-state municipal bond interest, and most would effectively be required to forego taxing the interest on all outstanding out-of-state municipal bonds. Only Congress could craft a purely prospective remedy that applied solely to municipal bonds that have not yet been issued. It therefore makes sense for the Court to stay its hand, as it has done before in state tax decisions raising similar issues of institutional competence. Even if a rule requiring the States to tax in-state and out-of-state bonds equally could be shown to be good policy, Congress is the branch of government best positioned to fashion a political solution in such a complex area with massive fiscal ramifications.

2. In *United Haulers Assn., Inc.* v. *Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786 (2007), this Court held that state laws that "favor the government," that "treat every private business, whether in-state or out-of-state, exactly the same," and that concern "a traditional government activity," "do not discriminate against interstate commerce for purposes of the Commerce Clause." *Id.*, at 1790. Kentucky's personal income tax exemption for interest earned on in-state municipal bonds meets each of these criteria. It favors the government, as the exemption applies only to interest on bonds issued by Kentucky and its political subdivisions. It

provides no advantage to Kentucky businesses over their out-of-state competitors. And it concerns a governmental activity that dates to the colonial period and, like waste management in *United Haulers*, is central to state and local governments' ability to carry out their governmental obligations. Thus, Kentucky's tax exemption does not discriminate against interstate commerce.

Because Kentucky's tax exemption is not discriminatory, it is constitutional if it does not impose a burden on interstate commerce that is "clearly excessive in relation to the putative local benefits." *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). The exemption's local benefits are substantial, while its economic impact is not properly understood as a "burden" on interstate commerce for purposes of the dormant Commerce Clause, let alone one that is "clearly excessive." The exemption's principal effect is to shift the geographic distribution of the investors purchasing a given State's municipal bonds, such that a larger proportion of those investors holding Kentucky municipal bonds are Kentucky residents. But this is a natural and salutary consequence of the distinctive relationship between a sovereign and its citizens, not a distortion of interstate commerce.

ARGUMENT

I. STATE GOVERNMENTS HAVE REASONABLY RELIED ON THE CONSTITUTIONALITY OF TAX EXEMPTIONS LIKE KENTUCKY'S, AND CONGRESS IS IN THE BEST POSITION TO ALTER THE STATUS QUO

Since the inception of modern state income taxes during the Progressive Era, state governments have granted preferential tax exemptions for the interest earned on in-state municipal bonds and have had no reason to question their validity. Congress plainly has the authority under the Commerce Clause to regulate the States' taxation of interstate

commerce, yet it has never seen fit to interfere with this practice. Although this Court is generally reluctant to draw inferences from congressional silence, in this particular context Congress's inaction warrants significant consideration, especially given the extensive evidence of Congress's awareness of the practice. Currently, 42 States provide income tax preferences for in-state municipal bonds, and myriad state and local governments have structured their budgets in reliance on these exemptions' constitutionality. Consequently, a decision to invalidate Kentucky's tax scheme would force state treasuries to absorb billions of dollars in transition costs, a large-scale financial disruption that is manifestly unfair given the reasonableness of the States' reliance on the validity of a ubiquitous tax policy.

The principal reason the States would incur these costs is that this Court's decision could apply retroactively. State governments might be forced to refund hundreds of millions of dollars in taxes paid on out-of-state municipal bond interest, and most States would effectively be required to forego taxing the interest on all outstanding out-of-state municipal bonds. Only Congress could craft a purely prospective remedy that applied solely to municipal bonds that have not yet been issued. These practical considerations suggest that the Court should stay its hand, as it has done in several prior state tax decisions raising similar issues of institutional competence. For even if one concluded that interstate commerce might benefit from the States' equal treatment of in-state and out-of-state municipal bonds, Congress is the only institution capable of crafting an equitable transition to such a regime.

A. Longstanding Historical Practice Supports the Constitutionality of State Tax Exemptions for Interest Paid on In-State Municipal Bonds

American state and local governments have imposed various forms of personal income taxes since the colonial

period. See 2 J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 20.01 (2007). Wisconsin enacted the first modern personal income tax in 1911, and several other States quickly followed suit. See *id.* From their inception, these state income tax codes have exempted the interest earned on municipal bonds issued by the taxing State, and they have denied this benefit to the interest earned on bonds issued by their sister States. New York adopted such a preference in 1919, see 1919 N.Y. Laws 1641–42, North Carolina in 1921, see 1921 N.C. Sess. Laws 207-208, and Virginia in 1926, see 1926 Va. Acts 961. Today, 42 States offer some form of tax preference for the interest earned on in-state municipal bonds.[2] And until the Kentucky Court of Appeals' handed down its decision in this case, no court in the United States, state or federal, had held that this differential tax treatment of in-state and out-of-state municipal bonds was unconstitutional. See 1 Hellerstein & Hellerstein, ¶ 4.13.

As this Court has recognized on several occasions, Congress "unquestionably" has the authority under the Commerce Clause to regulate the States' taxation of interstate commerce. *Camps Newfound/Owatonna, Inc.* v. *Town of Harrison*, 520 U.S. 564, 572 (1997). See also *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992); *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 280 (1978); *Prudential Ins. Co.* v. *Benjamin*, 328 U. S. 408, 434 (1946). And Congress has invoked this authority on numerous occasions to protect interstate commerce from various burdens it has deemed inconsistent with the national interest. See, e.g., Pub. L. No. 86–272, 73 Stat. 55, codified at 15 U.S.C. §381 (prohibiting the States from imposing income taxes on businesses that keep their contacts within the taxing State beneath a specific threshold); Internet

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[2] Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming impose no taxes on personal income, 2 Hellerstein & Hellerstein ¶ 20.01 n. 5, while Indiana does not distinguish in-state from out-of-state municipal bonds, see Ind. Code Ann. § 6–3–1–3.5.

Tax Nondiscrimination Act, Pub. L. No. 108–435, 118 Stat. 2615 (2004) (prohibiting States from imposing taxes on internet access or "discriminatory taxes on electronic commerce"); Pub. L. No. 104–95, 109 Stat. 979, codified at 4 U.S.C. §114 (restricting the States' authority to tax the retirement income of nonresidents); Soldiers' and Sailors' Civil Relief Act of 1940, Act of Oct. 17, 1940, ch. 888, § 514, as amended, 50 App. U.S.C. §571 (limiting the States' power to tax the property and personal income of military personnel); Railroad Revitalization and Regulatory Reform Act of 1976 (the 4-R Act), Pub. L. No. 94–210, 90 Stat. 54, codified at 49 U.S.C. §11501 (prohibiting States from imposing higher taxes on railroad property than on other commercial or industrial property).[3]

States have maintained these tax preferences for their own municipal bonds for nearly a century, and Congress has plainly been aware of the practice. See Br. *Am. Cur.* North Carolina et al. at 19-21 (collecting cases and legislative authorities); Br. *Am. Cur.* National Association of State Treasurers at 14-16 (same). Yet Congress, though it "has the power to protect interstate commerce," "is so far content to

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[3] *See also* 15 U.S.C. §391 (prohibiting the States from imposing a tax on "the generation or transmission of electricity which discriminates against out-of-State manufacturers, producers, wholesalers, retailers, or consumers of that electricity"); Pub. L. No. 94–29, 89 Stat. 97, codified at 15 U.S.C. §78bb(d) (limiting the States' power to impose stock transfer taxes); Employee Retirement Income Security Act (ERISA), 29 U.S.C. §1144(a) (dictating that ERISA "shall supersede any and all State laws insofar as they now or hereafter relate to any employee benefit plan," including state tax laws); 49 U.S.C. §§14502(b), 40116(d)(2)(A) (extending the protections of the 4-R Act to property owned by motor and air carriers); 49 U.S.C. §§14505, 40116(b) (prohibiting the States or their political subdivisions from taxing the interstate transportation of passengers by motor carrier or in air commerce); 49 U.S.C. §40116(c) (permitting state or local taxes "related to a flight of a commercial aircraft or an activity or service on the aircraft only if the aircraft takes off or lands in the State or political subdivision as part of the flight").

let the matter rest." *Commonwealth Edison Co.* v. *Montana*, 453 U. S. 609, 637 (1981) (White, J., concurring)

To be sure, "[s]tanding alone, historical patterns cannot justify contemporary violations of constitutional guarantees," *Marsh* v. *Chambers*, 463 U.S. 783, 790 (1983), and "[t]his Court generally is reluctant to draw inferences from Congress' failure to act," *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 306 (1988). Moreover, the Court has stated that Congress must indicate its intent with "unmistakable clarity . . . to permit state regulation that discriminates against interstate commerce." *Barclays Bank PLC* v. *Franchise Tax Bd. of Cal.*, 512 U. S. 298, 323 (1994). See also *Wyoming* v. *Oklahoma*, 502 U.S. 437, 458 (1992). But, for the reasons set out in Part II *infra*, Kentucky's tax exemption does not discriminate against interstate commerce. And the Court has acknowledged that, when the question at hand concerns whether the States' tax policies impermissibly burden interstate commerce, Congress's silence is important. See *General Motors Corp.* v. *Tracy*, 519 U. S. 278, 304–305 (1997); *Joseph* v. *Carter & Weekes Stevedoring Co.*, 330 U.S. 422 (1947), overruled on other grounds, *Department of Revenue of Wash.* v. *Association of Wash. Stevedoring Cos.*, 435 U. S. 734 (1978).

In *Carter & Weekes Stevedoring*, the Court held that, because "the power lies in Congress under the [Commerce] Clause to make any desired adjustment in the taxation area, its acquiescence in [this Court's] former rulings on state taxation indicates its agreement with the adjustments of the competing interests of commerce and necessary state revenues." 330 U.S., at 428. Of course, the Court has not squarely addressed whether the economic burdens and benefits attributable to tax exemptions like Kentucky's are consistent with the dormant Commerce Clause. In this case there is no *judicial* ruling in which Congress has acquiesced; instead, Congress has tacitly endorsed a widespread, long-

standing, and uninterrupted practice by the States that, until very recently, has gone unchallenged. But this distinction should have no constitutional significance. In our federal system—and with respect to a matter that Congress is expressly charged by the Constitution to superintend, see Art. I, §8, cl. 3—Congress's tacit approval of the States' consistent and longstanding judgments should be entitled to the same consideration and respect as its silent approval of this Court's holdings.

B. A Judicial Declaration that Kentucky's Tax Exemption Is Unconstitutional Would Disrupt the States' Substantial Reliance Interests

In light of the exemptions' deep historical roots, all but eight States have structured their financial affairs around the assumption that providing a tax preference for the interest earned on in-state municipal bonds is constitutional. A decision by this Court to invalidate Kentucky's tax scheme would therefore impose severe financial hardships on state governments, transition costs that are patently unfair given the States' reasonable reliance on the constitutionality of exemptions like Kentucky's.

Perhaps these consequences would not be disquieting had the States persisted in imposing income taxes that they had good reason to believe were unconstitutional. Cf. *McKesson Corp.* v. *Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 46–50 (1990) (discussing Florida's continued imposition of a liquor tax that was blatantly protectionist and only cosmetically different from a Hawaii liquor tax that the Court had previously invalidated). But that is not the case here. The States, like most other observers, were caught completely off guard by the Kentucky Court of Appeals' decision. See T. DeSue, *Ky. Ruling Would Lift Tax on Out-of-State Bonds*, Bond Buyer, Jan. 10, 2006, at 1 (quoting a bond industry executive who called the decision "earth shattering"). Before

January 2006, state governments had little reason to believe that these tax exemptions were constitutionally suspect, and they acted accordingly. To force the States to shoulder these breathtaking transition costs, despite their reasonable and substantial reliance on extant understandings of the dormant Commerce Clause, is wholly inequitable.

To appreciate what is at stake for the States, it is useful to isolate the implications of this case for two distinct (but overlapping) groups of taxpayers. The first group is taxpayers who have recently paid state income tax on interest earned on out-of-state municipal bonds. The second and far more significant group is taxpayers who presently own out-of-state municipal bonds. With respect to the first group, a decision to invalidate Kentucky's tax exemption may well require the States to disgorge hundreds of millions of dollars in tax refunds. With respect to the second group, it would effectively force the States to forego *billions* of dollars in income tax revenue well into the future. These are dollars on which the States' budgets critically depend. And these are transition costs that the States would be forced to shoulder merely because they have incurred debt obligations based on a reasonable understanding of the dormant Commerce Clause.

1. *Taxpayers who have recently paid taxes on interest earned on out-of-state municipal bonds.* As a threshold matter, there is a significant possibility that a ruling by this Court to invalidate Kentucky's tax exemption would apply retroactively. Granted, this Court's precedent has "left unresolved the precise extent to which the presumptively retroactive effect of this Court's decisions may be altered in civil cases." See *Harper* v. *Virginia Dept. of Taxation*, 509 U.S. 86, 96 (1993). But the Court held in *Harper* that "[w]hen this Court applies a rule of federal law to the parties before it, that rule . . . must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our

announcement of the rule." 509 U.S., at 97. Thus, a decision invalidating Kentucky's tax exemption could apply retroactively to all similarly situated taxpayers nationwide.

Further, the Due Process Clause could require that this retroactive remedy "provide meaningful backward-looking relief to rectify any unconstitutional deprivation." *McKesson*, 496 U.S., at 31. In a case like this, where the claim is that the State's tax scheme discriminates against interstate commerce, such relief could take three forms, any of which would remedy the constitutional problem: (1) the States could refund all taxes paid on any interest earned on out-of-state municipal bonds; (2) the States could retroactively impose a tax on any interest earned on in-state municipal bonds; or (3) the States could enact some combination of the two that results in the equal tax treatment of all municipal bond interest during the relevant time period. See *id.*, at 40–41.

Although each of these options would be open to the States in theory, "[i]n the real world, . . . the practical and political difficulties of fashioning any retroactive remedy other than a refund (as well as legal difficulties presented by federal and state strictures regarding retroactive legislation) make solutions that require back-tax collections unlikely." W. Hellerstein & D. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 Cornell L. Rev. 789, 873 (1996). Thus, the States could be required to award refunds to every taxpayer who had paid income tax on interest earned on out-of-state municipal bonds within the relevant limitations period, unquestionably a substantial liability. For instance, in 2003 New York residents reported $636.4 million of interest income from out-of-state municipal bonds. D. Denison et al., *Davis v. Department of Revenue of Kentucky: A Preliminary Impact Assessment*, IFIR Working Paper No. 2007–03 (2007), at pp. 13–14, available at http://www.ifigr.org/publication/ifir_working_papers/IFIR-WP-2007-03.pdf (last visited July 16, 2007). New York's

estimated tax revenue from this interest was $45.8 million. *Id.*, at 14. For Connecticut, the estimated income tax revenue in 2004 from out-of-state municipal bond interest and the dividends paid by municipal bond mutual funds was $70.9 million. *Id.* Thus, the immediate tax refund liability for the States as a whole could run well into the hundreds of millions of dollars.

2. *The tax treatment of outstanding municipal bonds.* While substantial, the States' immediate liability for tax refunds would pale in comparison to the fiscal consequences related to the taxation of the interest yet to be earned on outstanding out-of-state municipal bonds. Again, a decision invalidating Kentucky's tax exemption would require the States to treat all municipal bonds equally. For the interest earned on municipal bonds that have already been issued, the States would have two choices in providing an adequate remedy: (1) they could tax the interest earned on in-state municipal bonds, or (2) they could exempt the interest earned on out-of-state municipal bonds.

For most States, the option of taxing the interest earned on in-state municipal bonds that investors have already purchased would be impracticable, if not legally foreclosed. In-state investors have purchased these bonds in reliance on their favorable state tax treatment. For most in-state investors, the state tax exemption is a critical aspect of the transaction: They have accepted a lower yield in exchange for the state income tax benefit, such that they still receive a competitive after-tax rate of return on their investment. Thus, taxing the interest on in-state municipal bonds that taxpayers have already acquired would be inequitable, if not a breach of contract. It would change the rules on the bondholders midstream, forcing them to accept an after-tax rate of return well below that of comparable investments.

This means that to treat in-state and out-of-state municipal bonds equally, most States would likely be forced to abstain

from taxing any interest earned by their taxpayers on outstanding out-of-state municipal bonds. The fiscal repercussions of such a mandate would be astounding. As discussed above, the revenue loss for the States *for a single year* would run well into the hundreds of millions of dollars. See Denison et al., *supra*, at pp. 13–14. Given that many outstanding bonds will not mature for another thirty years, affirmance of the judgment below would cost state governments billions of dollars in foregone tax revenue.

C. If a Change in the State Tax Treatment of Municipal Bond Interest Is Desirable, Congress Is in the Best Position to Make that Change

For the reasons discussed in Part II, *infra*, *amici* believe that Kentucky's tax exemption is constitutional. Even if respondents were correct on the law, however, all of the attendant transition costs could be avoided if the substantive rule that they seek—the equal state tax treatment of in-state and out-of-state municipal bonds—could be applied purely prospectively. That is, these financial dislocations would disappear if any mandate of equal tax treatment were to apply only to municipal bonds issued in the future. For the reasons discussed earlier, however, this Court generally cannot fashion such relief. The only branch of government capable of adopting such a rule, without simultaneously imposing massive costs on state treasuries, is Congress.

There is a strong tradition of this Court deferring to Congress's superintendence of interstate commerce in cases raising similar issues of institutional competence, particularly when they involve matters of state and local taxation. For example, *Moorman Mfg. Co.* v. *Bair* addressed Iowa's single-factor formula for apportioning the income of interstate businesses. The plaintiffs demonstrated that Iowa's method of apportionment likely subjected a number of out-of-state taxpayers to multiple taxation, and thus disadvantaged inter-

state commerce. See 437 U.S., at 276–277. But the Court reasoned that it was ill-suited to resolve the controversy, as doing so would have effectively required the Court to choose a particular method of apportioning income under the guise of interpreting the dormant Commerce Clause, which it declined to do. *Id.*, at 278–280. "It is clear," the Court held, "that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions." *Id.*, at 280.

Commonwealth Edison Co. v. *Montana* involved a severance tax that Montana imposed on all coal mined in the State. Because the tax rate was extremely high, and because its incidence fell predominantly on out-of-state electricity consumers, the plaintiffs asserted that Montana had effectively exported its tax burden to other States. See 453 U.S., at 617–618. But because a holding in favor of the taxpayers would have forced the Court to make a range of difficult empirical economic judgments, it upheld the State's tax scheme and left the ultimate resolution to Congress: "Under our federal system, the determination is to be made by state legislatures in the first instance and, if necessary, by Congress, when particular state taxes are thought to be contrary to federal interests." *Id.*, at 628. Despite some reservations, this Court declined to intervene. See *id.*, at 637 (White, J., concurring) ("This is a very troublesome case for me, and I join the Court's opinion with considerable doubt and with the realization that Montana's levy on consumers in other States may in the long run prove to be an intolerable and unacceptable burden on commerce" but "Congress has the power to protect interstate commerce from intolerable or even undesirable burdens").

Perhaps the most analogous case is *Quill Corp.* v. *North Dakota*, which addressed whether a State could require an out-of-state vendor to collect use taxes on sales to the taxing State's consumers, even when the vendor had no physical presence in the taxing State. See 504 U.S. at 301. The Court had invalidated an identical collection obligation 25 years earlier in *National Bellas Hess, Inc.* v. *Department of Revenue of Ill.*, 386 U. S. 753 (1967), and "the *Bellas Hess* rule . . . engendered substantial reliance and has become part of the basic framework of a sizable industry." *Quill*, 504 U.S., at 317. Despite some evident ambivalence, see *id.*, at 315, 317 (conceding that the physical presence requirement "appears artificial at its edges" and that the Court had rejected a "similar bright-line, physical-presence requirement" in other state tax cases), the Court reaffirmed the rule of *Bellas Hess*. It concluded that, although there were problems with the rule, Congress was in the best position to alter the status quo. See *id.*, at 317–318. "[T]he underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions." *Id.*, at 318 (footnote omitted).

Moorman, *Commonwealth Edison*, and *Quill* together represent a critical strand of this Court's dormant Commerce Clause jurisprudence. Specifically, they show that even when state laws arguably burden interstate commerce, the judicial disruption of the status quo may not be the wisest course, particularly in the field of taxation. Reasons of institutional competence can dictate that the controversy is simply not meet for judicial resolution.

This is such a case. Even assuming some change in state tax treatment of bond interest were needed, Congress is the only institution capable of devising an equitable transition to a system in which the States' tax the interest on in-state and out-of-state municipal bonds equally. Cf. *United Haulers*,

127 S. Ct. at 1797 n. 7 ("Congress retains authority under the Commerce Clause as written to regulate interstate commerce, whether engaged in by private or public entities.").

In the concluding paragraph of the majority opinion in *Quill*, the Court offered the following insight:

> [E]ven if we were convinced that *Bellas Hess* was inconsistent with our Commerce Clause jurisprudence, this very fact might give us pause and counsel withholding our hand, at least for now. Congress has the power to protect interstate commerce from intolerable or even undesirable burdens. In this situation, it may be that the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.

504 U.S., at 318–19 (internal quotation marks, alterations, and citations omitted). The same is true here. Given the enormous reliance interests at stake, Congress is the branch of government best suited to craft a solution if one is needed.

II. UNDER *UNITED HAULERS*, KENTUCKY'S TAX EXEMPTION FOR INTEREST EARNED ON IN-STATE MUNICIPAL BONDS DOES NOT VIOLATE THE DORMANT COMMERCE CLAUSE

In *United Haulers*, this Court held that state laws granting a preference to the government generally do not discriminate against interstate commerce for purposes of the dormant Commerce Clause. Specifically, "laws favoring local government" with respect to "a customary and traditional government function," but which treat "all private companies exactly the same," "do not discriminate against interstate commerce." 127 S. Ct., at 1795–1797 & n. 7 (order of quotations altered). The tax exemption challenged here meets all three of these criteria. It favors the government, as it only covers interest earned on bonds issued by Kentucky and its municipalities; it treats all private businesses exactly the

same; and it concerns an activity—borrowing money—that is a traditional and core governmental function. It therefore does not discriminate against interstate commerce. Finally, because the economic impact of Kentucky's tax exemption is not a cognizable "burden" on interstate commerce, let alone one that is clearly excessive relative to its local benefits, the exemption does not violate the dormant Commerce Clause.

A. A State Tax Exemption for Interest Earned on Bonds Issued by the Taxing State and Its Political Subdivisions Does Not Discriminate Against Interstate Commerce

In *United Haulers*, a coalition of waste haulers contended that two county "flow control" ordinances violated the dormant Commerce Clause. In particular, they argued that the ordinances discriminated against interstate commerce because they prohibited the haulers from delivering trash to out-of-state processing facilities at lower cost. *Id.*, at 1792. The Court had confronted a nearly identical ordinance thirteen years earlier in *C & A Carbone, Inc.* v. *Clarkstown*, 511 U.S. 383 (1994), and found the regulation unconstitutional. The "only salient difference" between the two cases was that the favored facility in *Carbone* was privately owned, whereas the favored facilities in *United Haulers* were owned and operated by local government. *United Haulers*, 127 S. Ct., at 1790.

This sole difference was "constitutionally significant"—indeed, dispositive—leading the Court to conclude that the flow control ordinances did not discriminate against interstate commerce. *Id.* As the Court noted, there are several "[c]ompelling reasons" that justify treating laws that benefit the government differently from those that benefit in-state private businesses under the dormant Commerce Clause. *Id.*, at 1795.

First, unlike private businesses, "government is vested with the responsibility of protecting the health, safety, and welfare

of its citizens." *Id.* (citing *Metropolitan Life Ins. Co. v. Massachusetts*, 471 U.S. 724, 756 (1985)). Laws favoring state and local governments therefore "may be directed toward any number of legitimate goals unrelated to protectionism." *Id.*, at 1796. Second, treating public and private entities alike for purposes of the dormant Commerce Clause "would lead to unprecedented and unbounded interference by the courts with state and local government." *Id.* Though the Commerce Clause plays an important role in preventing state and local governments from engaging in economic protectionism, it "is not a roving license for federal courts to decide what activities are appropriate for state and local government to undertake." *Id.* Finally, courts should be "particularly hesitant to interfere with [government] efforts under the guise of the Commerce Clause" when the activities in question are "both typically and traditionally a local government function." *Id.* (internal quotation marks and citation omitted).

The essential holding of *United Haulers* was succinct: "laws that favor the government" in areas of "traditional government activity," but which "treat every private business, whether in-state or out-of-state, exactly the same," "do not discriminate against interstate commerce for purposes of the Commerce Clause." *Id.*, at 1790. The logic of that holding dictates that Kentucky's tax exemption is not discriminatory.

First, Kentucky's tax exemption favors the Commonwealth and its political subdivisions, not private business interests. Because of the tax exemption, Kentucky taxpayers are willing to accept a lower pre-tax rate of return on in-state municipal bonds. This means that Kentucky and its political subdivisions can issue their bonds at a considerably lower interest rate than the market would require absent the exemption. Thus, the beneficiaries of the tax exemption are not Kentucky bondholders; the market largely accounts for their favorable tax treatment by reducing their yield on the

tax-preferred bonds. See Cole et al., *The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields*, 7 J. Financial & Strategic Decisions 67, 68 (1994), available at http://www.studyfinance.com/jfsd/pdffiles/v7n2/cole.pdf (last visited July 16, 2007) (finding 100% capitalization of the state tax exemption benefit in the yield of municipal bonds).

The beneficiaries are the Commonwealth and its political subdivisions, which are able to borrow at a considerably lower interest rate, reducing their costs in raising capital. This, in turn, enables them to finance a range of public services and public works. See J. W. Temel, *The Fundamentals of Municipal Bonds* 53–55 (5th ed. 2001) (explaining that lower debt-service costs enable state and local governments to finance such public works as schools, roads, bridges, airports, public power facilities, sewers, hospitals, fire stations, affordable housing, mass transit facilities, and universities).[4] Of course, it is conceivable that the tax exemption

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[4] Municipal bonds fall into two basic categories: governmental bonds and private activity bonds. *See* C. Belmonte, *Tax-Exempt Bonds, 1996–2002* at 151-52 (SOI Bulletin Summer 2005), available at http://www.irs.gov/pub/irs-soi/02govbnd.pdf (last visited July 17, 2007). Governmental bonds have no statutory definition. See Public Finance Network, *Tax-Exempt Financing: A Primer* 3 (rev. ed., n.d.). They are generally issued to finance facilities that are owned, controlled, and operated by state or local governments, such as schools, streets, and utilities. *See id.*, at 2; Belmonte, *supra*, at 155.

Private activity bonds are defined by § 141 of the Internal Revenue Code. *See* 26 U.S.C. §141. In brief, a municipal obligation will be considered a private activity bond, "irrespective of the purpose for which it is issued or the source of payment, if (1) more than 10 percent of the proceeds of the issue will finance property that will be used by a nongovernmental person in a trade or business, and (2) the payment of debt service on more than 10 percent of the proceeds of the issue will be (A) secured by property used in a private trade or business or payments in respect of such property, or (B) derived from payments in respect of property used in a private trade or business." Temel, *supra*, at 251. Roughly three-fourths of the municipal bond market consists of govern-

actually costs Kentucky more in foregone tax revenue than it delivers in reduced borrowing costs. See Cole et al., *supra*, at 68, 72. But the relevant point for purposes of *United Haulers* is that, to the extent the exemption provides a benefit, that benefit runs to the government.[5]

Second, Kentucky's tax scheme treats all private business interests identically. The Kentucky tax code includes all bond interest in income, with the sole exception of the interest earned on bonds issued by the Commonwealth or its political subdivisions. See Ky. Rev. Stat. Ann. §§ 141.010(9), 141.010(10)(c). Every private issuer of debt is treated the same, regardless of its location. The law grants no advantage to Kentucky businesses—whether they are bond issuers, bond dealers, bond brokers, or bond holders—over their out-of-state competitors.[6]

Consequently, Kentucky's tax exemption does not represent the sort of economic protectionism with which the dormant Commerce Clause is chiefly concerned. This is not a law that "burden[s] out-of-state producers or shippers simply to give a competitive advantage to in-state *businesses*." *Granholm* v. *Heald*, 544 U.S. 460, 472 (2005) (emphasis added). Nor is it a law that "give[s] local consumers

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mental bonds, and one-fourth of private activity bonds. *See* Belmonte, *supra*, at 151 (between 1996 and 2002 more than $1.5 trillion in governmental bonds and $548 billion in private activity bonds were issued).

[5] As discussed in more detail *infra* at 20 & 25-26, Kentucky's exemption also furthers the legitimate objectives of decentralizing control over the Commonwealth's fiscal affairs and encouraging more state citizens to become genuine stakeholders in their community.

[6] Of course, the issuance of municipal bonds will produce benefits for private contractors that perform the projects that are financed by the bonds. But the same is true of any public spending, whether financed through bonds, taxes, license fees, or a grant from the federal government. This Court has never considered the existence of such benefits, in itself, "protectionist."

an advantage over consumers in other States." *Brown-Forman Distillers Corp.* v. *New York State Liquor Auth.*, 476 U. S. 573, 580 (1986).

Instead, the exemption operates as an implicit, intrastate transfer from the Commonwealth's pool of general revenue to those governmental units (including the Commonwealth itself) that choose to raise capital through the issuance of municipal bonds. The decision whether to issue municipal bonds is vested by state law in various governmental units and, through elections, their respective constituents. When these governments issue debt, the exemption offers an implicit subsidy by reducing the interest rate that the market will demand. The cost of this subsidy, however, is fully funded by Commonwealth itself: The Kentucky government must pay for it by relinquishing personal income tax revenue. In this sense, the tax exemption is indistinguishable in practical effect from a program under which the Commonwealth offered no tax exemption but made direct cash payments to its municipalities when they issued bonds, a program that would plainly be constitutional.

The exemption is therefore best understood as a policy choice by the Commonwealth about how to structure the financing of its various governmental units. Through the mechanism of the exemption, Kentucky has decided (1) to raise less revenue through personal income taxes and more through municipal bond issues, and (2) to decentralize the decisionmaking process concerning how much capital to raise and which public works to pursue. Those governmental units with the authority to issue bonds are empowered to use state general funds (in the form of foregone income tax revenue) to pursue projects that they believe are beneficial to their respective jurisdictions. Structuring state and municipal finances in this fashion is thus a political choice. And like the decision by Oneida and Herkimer Counties and New York State to displace private competition in waste processing with

a government-run monopoly, "nothing in the Commerce Clause vests the responsibility for that policy judgment with the Federal Judiciary." *United Haulers*, 127 S. Ct., at 1796.

Finally, the activity of borrowing money to finance the construction of infrastructure and other necessary public improvements is a "traditional government function." First, the practice has deep historical roots, predating the issuance of corporate debt by several centuries. See Temel, *supra*, at 49 (noting that Italian city-states borrowed from major merchant banking families during the Renaissance). American cities incurred debt as early as the seventeenth century. See *id.* New York City issued the first officially recorded municipal bond in 1812 to finance the construction of the Erie Canal. See Shafroth, *Which State Taxes Are 'Preferred' for Infrastructure?*, 40 State Tax Notes 237 (2006). By 1843, U.S. cities had accumulated approximately $25 million in outstanding debt, and the number of municipal bond issues has grown exponentially ever since. See Temel, *supra*, at 49–50. State and local governments issued $26 billion in municipal bonds in 1975, and they issued more than ten times that amount ($263.8 billion) in 1999. See *id.*, at 3. Presently, the value of outstanding U.S. municipal bonds is roughly $2.4 trillion. See T. Herman, *Justices to Hear Muni-Bond Case—Kentucky Tax Fight Over Exemptions Affects Many States*, Wall St. J., May 22, 2007, at D3.

Second, and more fundamentally, borrowing money is indispensable to state and local governments' capacity to provide essential but costly governmental services. See *South Carolina* v. *Baker*, 485 U.S. 505, 531 (1988) (O'Connor, J., dissenting) ("Long-term debt obligations are an essential source of funding for state and local governments."). There are approximately 87,000 state and local governments in the United States, U.S. Census Bureau, *Statistical Abstract of the United States: 2007*, at p. 264 (Table 415), and only the very largest are capable of financing any significant capital im-

provements exclusively from current revenue. Even for state governments, issuing bonds is often the only practical means to finance the construction of essential infrastructure, such as roads, highways, sewers, and utilities. Bond issues make these public investments possible by allowing state and local governments to spread the relevant tax burden over several years.

Issuing bonds is thus a temporal extension of a State's authority to tax, a power that is "basic to its sovereignty." *Bode* v. *Barrett*, 344 U.S. 583, 585 (1953). Municipal bonds permit governments to extend the time frame of taxation over the useful life of the capital improvement, rather than forcing them to impose the entire tax burden at the time of the improvement's construction. Moreover, bonds promote fairness in public finance by enabling state and local governments better to ensure that the citizens who benefit from long-term capital improvements (those who live in the community over the life of the assets) are those who pay for them (in taxes that go toward servicing the debts). Absent such a spreading of the tax burden, taxpayers required to fund the entire cost of public works at the time of their construction would have a strong incentive to undersupply these important public goods. Thus, there are powerful systemic reasons that local governments have incurred debt since colonial times, and that they continue to rely on it heavily today.

In short, Kentucky's tax exemption falls squarely within the rule announced in *United Haulers*: It favors state and local government, it treats all private businesses equally, and it concerns a traditional government activity. It necessarily follows that, for purposes of the dormant Commerce Clause, Kentucky's income tax exemption for interest earned on in-state municipal bonds does not discriminate against interstate commerce.

B. Kentucky's Tax Exemption Does Not Impose a "Clearly Excessive" Burden on Interstate Commerce

Because Kentucky's tax exemption does not discriminate against interstate commerce, the appropriate test under the dormant Commerce Clause is that set out in *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137 (1970), for laws that are "directed to legitimate local concerns, with effects upon interstate commerce that are only incidental." *City of Philadelphia* v. *New Jersey*, 437 U.S. 617, 624 (1978).[7] To pass muster, Kentucky must only show that the burden on interstate commerce attributable to the tax exemption is not "clearly excessive in relation to the putative local benefits." *Pike*, 397 U.S., at 142. Kentucky has made that showing here.[8]

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[7] Since 1977, this Court has typically applied the 4-part test originally articulated in *Complete Auto Transit, Inc.* v. *Brady*, 430 U. S. 274 (1977), to determine whether a challenged state tax provision is consistent with the dormant Commerce Clause. See, e.g., *Oklahoma Tax Comm.* v. *Jefferson Lines, Inc.*, 514 U. S. 175, 183 (1995); *Itel Containers Int'l Corp.* v. *Huddleston*, 507 U. S. 60, 73 (1993); *Trinova Corp.* v. *Michigan Dept. of Treasury*, 498 U. S. 358, 372 (1991); *Goldberg* v. *Sweet*, 488 U. S. 252, 259–260 (1989). Under *Complete Auto*, a state tax is permissible so long as it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto*, 430 U.S., at 279. Here, Respondents' only Commerce Clause claim appears to be that Kentucky's tax exemption discriminates against interstate commerce. See J.A. 24. Thus, if the Court concludes that the exemption is non-discriminatory, further analysis under *Pike* may be unnecessary. Cf. *General Motors v. Tracy*, 519 U.S. at 824 n. 12 (suggesting that *Pike* balancing is not required if *Complete Auto*'s apportionment prong is satisfied).

[8] Because the trial court upheld Kentucky's tax exemption on the ground that the Commonwealth was acting as a market participant, it did not reach the question whether the exemption satisfied *Pike*'s balancing test. *See* Pet. App. 18a–19a. Likewise, because the Kentucky Court of Appeals invalidated the exemption on the ground that it discriminated

First, Kentucky's tax exemption furthers several legitimate government objectives. It reduces the interest rate that Kentucky and its political subdivisions must pay when they issue bonds. It devolves greater power over the Commonwealth's fiscal affairs—how much money to spend, and which projects to fund—to local governments, which are better positioned to respond to their respective communities' needs. And it encourages Kentucky citizens to become personally invested in the construction of the Commonwealth's infrastructure, and indeed its future—its schools, universities, roads, utilities, hospitals, and low-income housing.

Second, the exemption's economic impact is not properly understood as a "burden on interstate commerce," let alone a burden that is "clearly excessive in relation to its putative benefits." The principal economic effect of the exemption is to alter the residential distribution of those persons holding Kentucky municipal bonds. It creates a financial incentive for Kentucky citizens, when they are purchasing municipal bonds, to purchase Kentucky bonds rather than those issued by another State. As a result, the proportion of investors holding Kentucky municipal bonds who are Kentucky citizens is substantially greater than it would be absent the exemption. The same is almost certainly true, to greater and lesser degrees, for all 42 States that offer a tax preference for the interest earned on in-state municipal bonds.[9] This ex-

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against interstate commerce, it did not address the *Pike* balancing question, either. *See* Pet. App. 4a–11a. Thus, no court has evaluated the exemption's local benefits or its impact on interstate commerce. For the reasons stated *infra*, we believe that, as a matter of law, the exemption's impact on interstate commerce is not a cognizable "burden" for purposes of the dormant Commerce Clause, and that this Court should therefore uphold the exemption under *Pike*.

[9] The strength of this incentive turns on the taxpayer's marginal state income tax rate. The effect is apt to be strongest for bonds issued by states like California, where the top marginal income tax rate is 9.3

plains the existence of the 400-odd state-specific mutual funds that various investment companies now market to investors.[10]

Though this practical consequence is rather obvious, it is not a "burden on interstate commerce." Although the exemption steers more Kentucky residents towards Kentucky municipal bonds, the Commonwealth's relationship to its residents is qualitatively different than that between a typical debtor and its creditors: It is the relationship between a sovereign and its citizens. "[A]s the guardian and trustee for its people," *Atkin* v. *Kansas*, 191 U.S. 207, 222 (1903), Kentucky has a strong interest in encouraging its citizens to be more than just consumers of the State's public services. Like any sovereign, it naturally desires its citizens to be genuine *stakeholders* in the Commonwealth and its municipalities

An investor's decision to purchase a municipal bond issued by his or her home State is also distinctive from the investor's perspective. After all, it is Kentucky citizens who will directly benefit from the projects financed by Kentucky's municipal bonds, and it is Kentucky citizens who, through their tax dollars, will pay off the interest on these bonds. *Cf. Reeves, Inc.* v. *Stake*, 447 U.S. 429, 442 (1980); *United Haulers*, 127 S.Ct. at 1797. A citizen's decision to invest in his or her own State therefore implicates important, non-financial considerations that are inapplicable to other commitments of capital. For all of these reasons, the fact that Kentucky taxpayers are more heavily invested in Kentucky

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percent, while it less significant for bonds issued by states like Connecticut, where the top marginal rate is 5 percent.

[10] According to the Investment Company Institute, at the close of 2006 there were 482 single-state municipal bond mutual funds with combined assets totaling $155 billion. *See* J. Mysak, *Trash-Hauler Case Muddies Water for Municipal Market*, Bloomberg, May 9, 2007, available at http://www.bloomberg.com/apps/news?pid=20601039&sid=aaVU49WiUSFs&refer=columnist_mysak (last visited July 16, 2007).

municipal bonds—both literally and figuratively—is not a "distortion" of interstate commerce. Instead, it is a natural and salutary consequence of the Nation's federal structure.

Moreover, Respondents' arguments about the beneficial economic effects that would flow from invalidating Kentucky's tax exemption are empirically unsupported and logically flawed. For instance, Respondents assert that, without theses tax exemptions, States "will compete for investors' dollars . . . on the merits of the projects funded by the investment sales," and that, "[a]s a result, the market will provide incentives for governments to be more careful in selecting and funding projects through bond sales." Brief in Opp. 11 n. 5. But that incentive already exists, and strongly so. For purposes of assessing the States' incentives, what matters are the effects of changes in their creditworthiness *at the margin*. Because the state tax exemption is largely capitalized into municipal bonds' yields, the tax exemption—while lowering the interest rate that state and local governments must offer—does nothing to diminish the *marginal* importance to them of remaining a good credit risk. Stated differently, a change in a state or local government's bond rating in a State with an exemption like Kentucky's is apt to have the same impact on that government's borrowing costs as it would absent the exemption.

Finally, the economic impact attributable to Kentucky's tax exemption is quite unlike the harms that this Court has found to constitute "clearly excessive" burdens on interstate commerce in its prior applications of *Pike*. It is not an idiosyncratic state regulation that, when combined with the laws of surrounding States, clogs the channels of interstate commerce. Cf. *Kassel* v. *Consolidated Freightways Corp. of Del.*, 450 U.S. 662 (1981); *Raymond Motor Transp., Inc.* v. *Rice*, 434 U.S. 429 (1978). It is not a law that operates extraterritorially, regulating commercial transactions that occur in other States. Cf. *Edgar* v. *MITE Corp.*, 457 U.S. 624

(1982). And it is not an explicit embargo that prohibits private businesses from transporting certain goods across state borders, as was the case in *Pike* itself. See 397 U.S. at 139.

Kentucky's tax exemption represents a preference by a sovereign for itself, in selling to its own citizens, over other sovereigns. Its effects are simply not comparable to anything this Court has previously held to be an impermissible burden on interstate commerce.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

Respectfully submitted,

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IN THE
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DEPARTMENT OF THE REVENUE
OF THE COMMONWEALTH OF KENTUCKY, AND
FINANCE AND ADMINISTRATION CABINET OF THE
COMMONWEALTH OF KENTUCKY, ET AL.,
Petitioners,

v.

GEORGE W. DAVIS AND KATHERINE V. DAVIS,
Respondents.

On Writ of Certiorari to
the Court of Appeals of Kentucky

BRIEF OF MULTISTATE TAX COMMISSION AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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BRIEF OF MULTISTATE TAX COMMISSION as *AMICUS CURIAE* IN SUPPORT OF PETITIONERS[1]

INTEREST OF AMICUS CURIAE

Amicus Curiae Multistate Tax Commission (Commission) files this brief in support of the Commonwealth of Kentucky. The Commission agrees with the Commonwealth that its tax treatment of bond interest income earned by its residents is not "discriminatory" for purposes of the dormant Commerce Clause.

The Commission is the administrative agency for the Multistate Tax Compact (Compact), which became effective in 1967. *See* RIA ALL STATES TAX GUIDE ¶ 701 *et seq.*, (2005). Today, forty-seven states and the District of Columbia are members of the Commission. Twenty have legislatively established full membership. Seven are sovereignty members and twenty-one are associate members.[2] This Court

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[1] No counsel for any party authored this brief in whole or in part. Only *Amicus* Multistate Tax Commission and its member states through the payment of their membership fees made any monetary contribution to the preparation or submission of this brief. This brief is filed by the Commission, not on behalf of any particular member state. Finally, this brief is filed pursuant to the consent of the parties.

[2] Compact Members: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Sovereignty Members: Georgia, Kentucky, Louisiana, Maryland, New Jersey, West Virginia and Wyoming. Associate Members: Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont and Wisconsin.

upheld the validity of the Compact in *United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978).

The purposes of the Compact are to: (1) facilitate proper determination of State and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes, (2) promote uniformity or compatibility in significant components of tax systems, (3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration, and (4) avoid duplicative taxation. *See* Compact, Art. I. These purposes are central to the very existence of the Compact, which was the states' answer to an urgent need for reform in state taxation of interstate commerce. *See e.g.*, H.R. Rep. No. 952, 89th Cong. 1st Sess., Pt. VI, at 1143 (1965). Substantial lack of uniformity had resulted in burdensome complexity and uncertainty, and in an elevated risk of duplicate taxation or less than full apportionment of income. If the states failed to act, Congress stood ready to impose reform itself through federal legislation that would preempt and regulate state taxation.[3]

The promise of increased uniformity established by the states' adoption of the Compact was critical to preserving the recognized sovereignty the states enjoyed, and continue to enjoy, with respect to taxation of interstate commerce. Preserving state tax sovereignty under our vibrant federalism remains a key purpose of the Commission. The importance

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[3] The Willis Committee, a congressional study of state taxation mandated by TITLE II OF PUB. L. NO. 86-272, 73 STAT. 555, 556 (1959), made extensive recommendations as to how Congress could regulate state taxation of interstate and foreign commerce. *See generally Interstate Taxation Act: Hearings on H.R. 11798 and Companion Bills Before Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary*, 89th Cong., 2d Sess. (1966).

the Commission attaches to the present case, and our motivation for filing this brief today, lies in this goal of preserving states' authority to determine their own tax policies within federal constitutional and statutory law, and in protecting that authority from a needlessly expansive interpretation of federal limitations. The Commission agrees with the Commonwealth of Kentucky that its treatment of bond interest income earned by its residents does not discriminate against interstate commerce; and that the expansive interpretation of the dormant Commerce Clause suggested by respondents would result in harmful and pointless pre-emption of the Commonwealth's and approximately 40 other states' lawful tax structures.

SUMMARY OF ARGUMENT

A state tax structure discriminates against interstate commerce in violation of the dormant Commerce Clause if it favors in-state private business interests and thereby impedes free trade in competitive national markets. Because the state tax structure at issue in this case favors the state itself in providing public services, which are not supplied in competitive national markets, and treats all private business interests the same, it does not discriminate against interstate commerce. There is no rationale for expanding the reach of the dormant Commerce Clause to prohibit differential tax treatment of state governments in addition to private business interests. State governments are sovereigns, for which the whole notion of competition, and the very concern of the Commerce Clause, does not apply. Competition would not be served by eliminating a tax differential as between States, and the dormant Commerce Clause has no job to do.

A nondiscriminatory state regulatory structure may be sustained where any unavoidable burdens it imposes on interstate commerce are outweighed by its benefits to the state.

Assuming *arguendo* a balancing of burdens and benefits also applies in the area of state taxation, a state's tax exemption for interest paid on its bonds should be sustained because it does not burden interstate commerce. There is no burden because the state government services supported with the bond proceeds are provided within the discrete boundaries of the state and not in competition with the public services of other states. Furthermore, the state and its residents receive substantial benefits from the tax exemption, in that the exemption encourages state residents who benefit from the services to defray the costs of those services by purchasing State bonds. The state also benefits because the tax exemption reduces the burden of administering a taxable bond program that would require the state to pay a higher interest rate on the bonds, with no net benefit either to the state or to the resident bond purchasers.

ARGUMENT

I. A STATE TAX STRUCTURE THAT FAVORS THE STATE ITSELF, BUT TREATS EVERY OTHER PUBLIC AND PRIVATE ENTITY THE SAME, DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE FOR PURPOSES OF THE DORMANT COMMERCE CLAUSE.

The 10th Amendment of the U.S. Constitution grants the federal government power to regulate only those matters specifically delegated to it. Other powers are reserved to the states, or to the people. One such federal delegation is contained in the Commerce Clause, which reserves for Congress the exclusive power "... [t]o regulate Commerce with foreign Nations, and among the several States." U.S. CONST. art. I, §8, cl. 3. This explicit delegation has long been held to contain a negative inference, restricting State authority even in the absence of an explicit federal regulation if the state action

would improperly discriminate against or burden interstate commerce. See, *e.g.*, *Quill Corp. v. North Dakota*, 504 U.S. 298, 312-313 (1992).

The question presented is whether a state tax structure discriminates against or burdens interstate commerce when it exempts the interest income earned by its residents on its own state and political subdivision bonds but taxes the interest income earned by its residents on other states' bonds.[4] The answer is "no" for the reasons set forth below.

A. A State Tax Structure Discriminates Against Interstate Commerce if it Favors In-State Private Interests Competing in National Markets.

The dormant Commerce Clause does not blindly prohibit every differential in state taxation. To be of concern, a differential must be relevant to the purposes of the Commerce Clause itself. The purposes of the Commerce Clause, from which the purposes of the dormant Commerce Clause flow, were explained by this Court in *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525 (1949):

> Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. *Such was the vision of*

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[4] KY. REV. STAT. ANN. §141.020(4)(2006)

> *the Founders; such has been the doctrine of this Court which has given it reality.*

336 U.S. 525, 539 (emphasis added)

Thus, the dormant Commerce Clause has been held to prohibit state taxes that discriminate against interstate commerce; where "interstate commerce" involves a national market place, and "discrimination" involves differential treatment of the private business interests competing in that market place. See, e.g., *Reeves, Inc. v. Stake*, 447 U.S 429, 437 (1980) (prohibiting a differential treatment that discriminates against interstate commerce thereby "imped[ing] free private trade in the national market place"); *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273-274 (1988) ("[The] 'negative' aspect of the Commerce Clause prohibits economic protectionism – that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors" (citations omitted); *General Motors v. Roger W. Tracy, Tax Commissioner of Ohio*, 519 U.S. 278, 299 (1997) (referring to "...the dormant Commerce Clause's fundamental objective of preserving national markets for competition undisturbed by preferential advantages conferred by a State upon its residents or resident competitors"); *In re Trade-Mark Cases*, 100 U.S. 82, 96 (1879) (For Commerce Clause purposes, "...commerce among the States means commerce between the individual citizens of different States...").

B. A State Tax Structure That Favors the State Itself Does Not Discriminate Against Interstate Commerce Because It Does Not Favor In-State Private Interests Competing in National Markets.

The beneficiary of the tax structure at issue in this case is the state itself, not in-state private businesses competing in a national market. As such, the tax structure does not discriminate against interstate commerce for purposes of the dormant Commerce Clause.

This Court recently considered the application of the dormant Commerce Clause in a similar case. In *United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste Management Authority* 550 U.S. ___, 127 S. Ct. 1786, 167 L.Ed.2d 655 (2007), two county governments adopted an ordinance requiring all waste haulers operating within their jurisdictions to utilize and pay tipping fees to the Counties' own waste processing facility. The Court noted "[t]he flow control ordinances ...benefit a clearly public facility, while treating all private companies exactly the same." *United Haulers*, 127 S.Ct. 1786, 1795. As such, the ordinances did not discriminate against interstate commerce.

The situation in the present case is analogous. Here, the State's issuance and tax treatment of its bonds benefit clearly public facilities. As explained by the National Association of State Treasurers in its brief as *amicus curiae* in support of petitioners on the Petition for Certiorari:

> State and local governments issue municipal bonds to raise funds to support general government needs or to fund public works projects and programs. Governments fund a wide range of capital projects through municipal bonds, including educational buildings at all levels from elementary schools to colleges and universities, government buildings, transportation facilities (including bridges, highways, and airports), public utility projects, hospitals, stadiums, and low income housing.

National Association of State Treasurers, Brief as *Amicus Curiae* in Support of Petitioners on Pet. for Cert. at 5

In *United Haulers*, the "ordinances [gave] the Counties a convenient and effective way to finance their integrated package of waste disposal services." 127 S. Ct. 1786, 1798 (Roberts, C.J.). Likewise in this case, Kentucky's issuance and tax treatment of its bonds give the Commonwealth a convenient and effective way to finance multitudes of government facilities supporting many state government services.

The direct beneficiary of this tax structure is the state itself, and ultimately the recipients of the state's services, not a particular class of in-state private businesses competing in a national market. Indeed, the bond interest income of all private entities is taxed exactly the same.

Thus, like the *United Haulers* case, this case does not implicate prior dormant Commerce Clause jurisprudence invalidating State tax and regulatory measures that discriminate in favor of in-state private business interests competing in a national market. See e.g., *Boston Stock Exchange v. State Tax Comm.* 429 U.S. 318 (1977); *C&A Carbone, Inc. v. Town of Clarkstown* 511 U.S. 383, 416 (1993) (Souter, J. dissenting) ("The outstanding feature of the statutes reviewed in the local processing cases is their distinction between two classes of private economic actors...").

In *United Haulers*, the Court recognized "[c]ompelling reasons justify treating these laws [favoring the County governments in their provision of government services] differently from laws favoring particular private businesses over their competitors." *United Haulers*, 127 S. Ct. 1786, 1795. Were the state's tax differential structured to exempt interest income earned by its residents on bonds issued by, for exam-

ple, in-state car manufacturers, while taxing the interest income earned by its residents on bonds issued by out-of-state car manufacturers, there could be discrimination against interstate commerce. But here, where the beneficiary of the tax differential is the state itself in its provision of government services, there is no differentiation between in-state and out-of-state business interests engaged in a competitive national market, and thus no discrimination against interstate commerce.

C. There is No Rationale for Expanding the Dormant Commerce Clause to Prohibit Differential Tax Treatment of State Governments in Addition to Private Interests.

States do not compete among themselves to supply state government services in a national market. Rather, each state is the exclusive provider of state government services within its own geographic borders. Because state government services are not supplied in a competitive national market, a state tax structure that benefits the state itself relative to the other states in the provision of such services does not discriminate against interstate commerce in any way that is relevant to the dormant Commerce Clause.

In *General Motors v. Tracy*, 519 U.S. 278 (1997), this Court considered a state sales tax exemption that applied to natural gas sales made by rate-regulated public utilities but not to natural gas sales made by unregulated natural gas marketers. The Court found the entities did not actually compete and considered the application of the dormant Commerce Clause:

> Conceptually, of course, any notion of discrimination assumes a comparison of substantially similar entities. ... [W]hen the allegedly competing enti-

> ties provide different products, ... there is a threshold question of whether the companies are indeed similarly situated for constitutional purposes. This is so for the simple reason that the difference in products may mean that the different entities serve different markets, and would continue to do so even if the supposedly discriminatory burden were removed. If in fact that should be the case, eliminating the tax or other regulatory differential would not serve the dormant Commerce Clause's fundamental objective of preserving a national market for competition undisturbed by preferential advantages conferred by a State upon its residents or resident competitors. ...[I]n the absence of actual or prospective competition between the supposedly favored and disfavored entities in a single market there can be no local preference, whether by express discrimination against interstate commerce or undue burden upon it, to which the dormant Commerce Clause may apply. *The dormant Commerce Clause protects markets and participants in markets; not taxpayers as such.*

519 U.S 278, 298-300 (emphasis added)

Each state provides its government services in its own, geographically distinct jurisdiction. There is no actual or prospective competition among the favored state and other states in a "market" for state government services. The consumers of state government services will be served by the state in which they reside, are domiciled, or are doing business; regardless of preferential tax treatment for that state's financing of its government services. Thus, the favored state and another state can never be similarly situated for constitutional purposes. Two states cannot similarly offer government ser-

vices in one jurisdiction. State governments are sovereigns, for which the whole notion of competition, and the very concerns of the Commerce Clause, do not apply. So far as financing for government services is concerned, "competition would not be served by eliminating any tax differential as between [states], and the dormant Commerce Clause has no job to do." *General Motors v. Tracy*, 519 U.S. 278, 303.

II. A STATE TAX STRUCTURE THAT FAVORS THE STATE ITSELF, BUT TREATS EVERY OTHER PUBLIC AND PRIVATE ENTITY THE SAME, DOES NOT IMPOSE A BURDEN ON INTERSTATE COMMERCE IN EXCESS OF ITS LOCAL BENEFITS.

Assuming *arguendo* that *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970) applies to a state tax structure, a nondiscriminatory statute will withstand a dormant Commerce Clause challenge under *Pike* "unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits." 397 U.S. 137, 142.[5]

A. A State Tax Structure That Favors the State Itself in Providing Government Services Does Not Burden Interstate Commerce.

First, Kentucky's financing program for government facilities used in the provision of its state government services imposes no discernible burden whatsoever on interstate commerce, because as explained above, there is no competitive national market for state government services.

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[5] Petitioners present a compelling argument that Pike is inapplicable in a dormant Commerce Clause challenge to a state tax statute. Brief of Petitioners, at n. 16.

Respondents seek to require that Kentucky subsidize the costs of bond financing in other states, even though neither the Commonwealth of Kentucky nor its residents - including the respondents – benefit from the services provided as a result of that financing. Nothing in this Court's Commerce Clause jurisprudence requires a state to subsidize the costs of a noncompetitive market that is available wholly outside of that State. *cf., General Motors v. Tracy*, 519 U.S. 278, 298-302 (tax exemption for sales by publicly owned utilities but not for sales by private utilities does not discriminate against out-of-state private utilities under Commerce Clause, because public and private utilities serve distinct, noncompetitive markets).

Next, the economic effects of Kentucky's limitation of its income tax exemption to bonds issued by the Commonwealth or its subdivisions are limited to the Commonwealth of Kentucky. Only Kentucky residents who purchase the bonds of other states or their subdivisions are affected by the denial of the tax exemption. Nonresidents that are subject to Kentucky income tax are not taxed on income from sources outside Kentucky. KY. REV. STAT. ANN. §141.020(4)(2006). The same is true in any state that limits the income tax exemption to bonds issued by itself or its subdivisions because a state may not constitutionally tax nonresidents on income derived from sources outside the taxing state. *Shaffer v. Carter*, 252 U.S. 37 (1920); *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920). While a state statute that discriminates against interstate commerce would not be sustained merely because its effects were limited to the state, *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. 241, 258 (1964); *Camps Newfound/Owatonna, Inc., v. Town of Harrison*, 520 U.S. 564, 573 – 574 (1997), the Court has made clear that when a regulatory scheme does not discriminate against commerce, "there is no reason for [the Court] to step in" when the eco-

nomic burden of the scheme is limited to that state. *United Haulers,* 127 S.Ct. 1786, 1797.

As was true in *United Haulers,* the economic burdens of Kentucky's limited income tax exemption fall entirely within Kentucky. As was the case in *United Haulers,* Kentucky residents have recourse to the political process in Kentucky if they wish to persuade the Kentucky legislature to expand the scope of the income tax exemption to include interest on out-of-state bonds as well as in-state bonds. Furthermore, the political interests of the out-of-state bond issuers are represented in Kentucky, as the economic interests of the Kentucky resident purchasers of those bonds are precisely congruent to the economic interests of the bond issuers.

B. A State Tax Structure That Favors the State Itself in Providing Government Services Creates Significant Benefits for the State and its Residents.

Not only are there no discernible burdens on interstate commerce as a result of Kentucky's nondiscriminatory financing scheme, but there are several significant benefits to the Commonwealth of Kentucky and to its residents that flow from that scheme.

First, the tax exemption for income derived from the bonds encourages Kentucky residents who benefit from government services provided by the Commonwealth and its subdivisions to purchase bonds to finance the costs of those services. It is clear that "while "revenue generation is not a local interest that can justify *discrimination* against interstate commerce," ... it is a cognizable benefit for purposes of the *Pike* test." *United Haulers,* 127 S. Ct. 1786 1798 (Roberts, C.J.), emphasis in original, citation omitted.

Conversely, there is no justification for requiring Kentucky to subsidize the costs of bond issuance by other states because the services made possible by those bonds do not as a general rule benefit Kentucky residents, including the respondents. If Kentucky were required to subsidize those costs, it would have to recover the costs, either by raising taxes or by reducing the interest paid on its own bonds. Either option would reduce the economic benefits of the bonds to Kentucky, its subdivisions and its residents. That in turn would make Kentucky bonds a less attractive investment to Kentucky residents.

Finally, the state is benefited from the income tax exemption because it reduces the administrative burdens that would accrue if the bonds were subject to tax. If the bonds were taxable, the state would need to raise the interest rate paid on the bonds in order to maintain their investment value. But doing so would needlessly increase the administrative burden of issuing the bonds, with no net benefit either to the state or to resident purchasers of the bonds, because the state would only recover, via taxation, the difference between the higher interest rate paid on taxable bonds and the lower rate on nontaxable bonds.

Kentucky's nondiscriminatory government services financing structure satisfies the *Pike* test as the benefits of that structure clearly outweigh the burdens.

CONCLUSION

A state tax structure that benefits the state itself relative to other states in the provision of state government services, but treats all private entities alike, does not discriminate against or burden interstate commerce for purposes of the dormant Commerce Clause. There is no rationale for expanding the dormant Commerce Clause beyond the purpose of the

Commerce Clause itself to prohibit differential treatment of state governments in addition to private entities.

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IN THE
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DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,

Petitioners,

v.

GEORGE W. DAVIS AND KATHERINE V. DAVIS,

Respondents.

ON WRIT OF CERTIORARI
TO THE COURT OF APPEALS OF KENTUCKY

BRIEF OF THE NATIONAL ASSOCIATION OF STATE TREASURERS AS AMICUS CURIAE SUPPORTING PETITIONERS

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INTEREST OF AMICUS CURIAE

The National Association of State Treasurers ("NAST") is a nonprofit association established in 1976.[1] NAST's members include the Treasurers, or similar financial officers, of all 50 States, the District of Columbia, the Commonwealth of Puerto Rico, and several territories of the United States. These officials typically function as the chief financial officers of their respective States with primary responsibility for a wide range of fiscal functions, including, in most instances, the State's direct debt issuance and other capital market operations. Many of these officials are also responsible for approving, or have other oversight responsibility for, the debt issuance and general fiscal affairs of political subdivisions and other public bodies within their respective States.

NAST's membership also includes corporate affiliate members that provide accounting, financial, legal, or other advisory services to NAST's public members. NAST's affiliate organizations include the State Debt Management Network, the professional network of public sector employees responsible for the management and issuance of State debt, and the College Savings Plans Network, the professional network of public sector employees responsible for the management and supervision of qualified tuition programs.

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[1] The parties have filed letters with the Clerk giving blanket consent to the filing of amicus briefs in this case. Pursuant to this Court's Rule 37.6, NAST states that no counsel for a party authored this brief in whole or in part. Nor did any person or entity, other than NAST, its members, or its counsel make a monetary contribution to the preparation or submission of this brief.

NAST and its affiliate organizations conduct professional education programs, engage in the development and implementation of best practices, and participate in the development of federal laws and administrative regulations affecting State fiscal affairs. In view of the role and responsibilities of NAST's public members in the issuance of public debt by States and their public bodies, NAST has a strong interest in whether State tax exemptions that are limited to municipal bonds issued by the State and its subdivisions violate the dormant Commerce Clause. NAST believes that its members' extensive experience in the field of municipal bonds and similar public programs may assist the Court in addressing that question.

STATEMENT

1. *Municipal Securities.* Municipal securities are obligations issued by State or local government entities. These entities include the States themselves, State-created authorities, incorporated local municipalities and local authorities. The most common form of municipal securities are municipal bonds, which represent a promise by the issuer to repay the investor the principal amount of the bond according to a fixed schedule, along with interest.

There are two main categories of municipal bonds: general obligation bonds and revenue bonds. General obligation bonds are backed by the full faith and credit of the issuer to apply all sources of revenue, unless specifically limited, to payment of principal and interest. *See* Judy Wesalo Temel, The Bond Market Association, *The Fundamentals of Municipal Bonds*, 55-56 (5th ed. 2001). Revenue bonds typically are backed by a particular stream of revenue rather than general tax revenues, and are used to fund specific projects that the issuer expects will generate revenue to service the debt

(or are secured by a specific existing revenue stream). *See id.* at 58. For example, bonds issued to raise money for an airport or toll road may be funded by airport fees or tolls.

Public bodies issue municipal bonds to raise funds to support essential government services and other government operating requirements, and to fund public works projects and programs. Uses funded through municipal bonds include government buildings, waste remediation, utilities, transportation facilities (*e.g.*, highways, bridges, railroads, seaports and airports), educational buildings at all levels from elementary schools to colleges and universities, hospitals, and single and multi-family housing.

2. *Importance of Municipal Bonds to State and Local Governments.* In the 25 years from 1975 through 1999, the total value of new short- and long-term municipal bonds issued grew tenfold, from $26 billion in 1975 to $263 billion in 1999. The Bond Market Association, *supra* at 3. More than $350 billion of long-term municipal bonds were issued by States in each year from 2002 through 2006.[2]

The total value of outstanding municipal bonds has also increased dramatically, from approximately $399 billion in 1980 to $1.5 billion in 2000. *Id.* at 17. The Census Bureau reported a combined $1.68 trillion in outstanding State and local government debt in 2001-02, $1.81 trillion in 2002-03, and $1.95 trillion in 2003-04.[3]

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[2] *The Bond Buyer/Thomson Financial Yearbook* 14-15 (2006); Matthew Hanson, *Volume in '06 a Near Record*, The Bond Buyer, January 2, 2007, at 1.

[3] U.S. Census Bureau, State and Local Government Finances, 2001-02 (Census); 2002-03; 2003-04, *all available at http://www.census.gov/govs/www/estimate.html* (last revised July 9, 2007).

The continuing increase in municipal bond issues reflects the critical importance of this source of funding for State and local operations and capital programs.

Municipal bonds provide benefits to the issuer and its citizen constituents, as well as to the purchasers of the bonds. The issuing authority is able to fund important but expensive public projects and programs that could not be paid for out of current tax revenues. Citizens derive immediate benefits from projects paid for with borrowed funds, which can be repaid with revenues collected over time as the project continues to provide benefits to taxpayers. Purchasers of municipal bonds benefit from a profitable and historically safe investment. Although the pre-tax rate of return on municipal bonds is typically lower than the return on other investment vehicles, that difference is offset by the tax-advantaged status of municipal bonds.

3. *Tax-Exempt Status of Municipal Bonds.* From an investor's perspective, municipal bonds are distinguished from other capital market securities by their eligibility for favorable tax treatment, which gives them an advantage over other types of investments. *See* Robert S. Amdursky & Clayton P. Gillette, *Municipal Debt Finance Law Theory and Practice* § 1.3.4 (1992); The Bond Market Association, *supra* at 27-29. The favorable tax treatment accorded to municipal bonds allows State and local government entities to obtain funding for public projects at a lower interest rate than would otherwise be available to them. Federal law provides a significant tax advantage by generally exempting interest on municipal bonds from federal income tax. A large majority of the States also exempt municipal bonds from State (and in some instances local) taxation. State and local tax exemptions can provide a significant additional advantage to municipal bonds as compared to other investments.

Since the Sixteenth Amendment was ratified in 1913, Congress has generally accorded tax-free status to municipal bonds. *See* 26 U.S.C. §§ 103, 141-50; The Bond Market Association, *supra* at 27. The tax-free status of municipal bonds allows the bond issuer to borrow money at a lower interest rate than it could obtain from other sources of financing. Investors are willing to accept lower interest rates precisely because of the advantages they gain from the tax exemption. *Id.*[4]

It would be misleading to compare the published interest rate of a municipal bond to that of an investment without favorable tax treatment, because taxes on non-exempt bonds reduce the after-tax return to the bondholder. To compare the rate of return of a tax-free bond to that of a taxable bond, investors use the following formula to calculate the rate of return on a taxable bond that will yield the same income as a tax-free bond:[5]

$$\frac{\text{municipal bond yield}}{(1 - \text{marginal tax rate})} = \text{comparable taxable bond rate}$$

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[4] The Securities Act of 1933 includes an exception to the Act's registration requirements for securities issued by a State or political subdivision. *See* 15 U.S.C. § 77c(a)(2). The exemption was intended to "correspond[] generally with the line drawn by the courts as to what obligations of States, their units and instrumentalities created by them, are exempted from Federal taxation." H.R. Rep. No. 73-85, at 14 (1933). *See generally* Robert A. Fippinger, *The Securities Law of Public Finance*, §§ 2.2, 2.9.5 (2d ed. 1999). Section 401 of the Employment Security Amendments of 1970 amended the Securities Act of 1933 and the Securities Exchange Act of 1934 to further delineate the special status of municipal securities under the federal securities laws.

[5] *See* The Bond Market Association, *supra* at 28-29.

For example, a bondholder with a 33 percent marginal federal tax rate in a State without income tax, who purchases a municipal bond paying 5 percent interest per year will earn interest equivalent to a taxable bond that pays approximately 7.5 percent interest.

In comparing municipal bonds to other investments, taxpayers take into account not only the federal taxes that would be due on the income, but also State and local taxes. A State tax exemption for in-State municipal bonds can have a significant impact on an investor's decision to purchase in-State versus out-of-State bonds. The "essential variable" in computing the equivalent yield between taxed and tax-free bonds is the investor's marginal tax rate. The Bond Market Association, *supra* at 27. An investor who resides in a State with an income tax who purchases bonds that are free from State taxation as well as federal taxation increases his or her equivalent taxable yield. *Id.*

Favorable State tax treatment of municipal bonds increases the marketability of municipal bonds, and exemptions from State and local taxation may be particularly important to smaller issuers and those with less than perfect credit ratings.[6] Investors have increasingly sought bonds that are exempt from State (and in some cases local) taxation as well as federal taxation, and mutual fund managers have created State-specific bond funds to meet that demand. *See* Jerry Webman, *Managing Single-State Municipal Bond Funds* in The Handbook of Municipal Bonds 339-350 (Susan C. Heide, Robert A. Klein & Jess Lederman eds., 1994). The

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[6] *See* Robert Lamb & Stephen P. Rappaport, *Municipal Bonds* 2, 25-26 (2d ed. 1987); Dwight Denison, *Bond Market Reactions to Hurricane Katrina: An Investigation of Prices and Trading Activity of New Orleans Bonds*, Municipal Finance Journal 39-52 (2006).

percentage of municipal bonds held by mutual funds increased substantially between 1980 and 1999, from 1.6 percent of outstanding bonds to 33.7 percent. The Bond Market Association, *supra* at 17. The popularity of State-specific bond funds demonstrates that investors view exemption from State taxation as an important consideration when investing in municipal bonds. These funds also provide essential market intermediation for smaller and lower-credit issuers.

4. *This Case*. Respondents, two individual Kentucky taxpayers, filed this action in the Circuit Court of Jefferson County, Kentucky challenging the Commonwealth's taxation of income received from out-of-State municipal bonds. Kentucky, like most States, does not tax interest earned on bonds issued by the Commonwealth or its subdivisions, but it does tax interest earned on bonds issued by other States or their subdivisions. *See* Ky. Rev. Stat. Ann. § 141.010(9), (10).

The trial court granted Petitioners' motion for summary judgment. Pet. App. A15-A19. The court held that municipal bonds fall within the "market participant" exception to this Court's dormant Commerce Clause. *See, e.g., Reeves, Inc.* v. *Stake*, 447 U.S. 429, 436-37 (1980); *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794, 808-09 (1976). Accordingly, the court held, a State "clearly may pay a higher rate of interest to resident purchasers based upon the theories of distributing state created benefits and market participation." Pet. App. A18. The court observed that "[e]ach state has a legitimate interest in drawing upon a major source of tax revenue while creating an incentive for investors to purchase state bonds." *Id.* at A19. Because Kentucky's taxation of out-of-State bonds has a "reasonable, legitimate public purpose," the court held that it is constitutional. *Id.*

The Kentucky Court of Appeals reversed. Pet. App. A1-A13. The court of appeals held that Kentucky's tax on

the income derived from bonds issued by States other than Kentucky is "facially unconstitutional" because "it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." *Id.* at A6.

The court of appeals rejected three arguments made by Petitioners in support of the constitutionality of Kentucky's tax code. *First*, the court declined to follow a decision of an Ohio appellate court holding that a similar taxation system does not violate the Commerce Clause. *See Shaper* v. *Tracy*, 647 N.E.2d 550 (Ohio Ct. App. 1994); Pet App. A7-A8. *Second*, the court held that this Court's decision in *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881), is inapposite because it addressed only the Full Faith and Credit Clause and not any issue under the Commerce Clause. Pet. App. A9. *Third*, the court rejected Petitioners' "market participant" argument. The court acknowledged that issuing bonds constitutes participation in the bond market, but it held that taxing income derived from bonds is an activity of the State as a market regulator. Because "the sole issue is Kentucky's decision to tax only extraterritorial bonds," the court held that "the market participant theory is inapplicable." *Id.* at A10.

The Supreme Court of Kentucky denied discretionary review of the court of appeals' decision. *Id.* at A14. This Court granted the petition for certiorari.[7]

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[7] NAST filed the lone *amicus curiae* brief in support of the petition, urging the Court to grant review to resolve the legal uncertainty created by the Kentucky court's decision.

SUMMARY OF ARGUMENT

1. State authority to exempt in-State municipal bonds from state taxation is a longstanding and widely-accepted aspect of State sovereignty. The States' authority to raise revenues includes the authority to issue public debt, because the issuance of debt is an indispensable alternative to taxation. For many decades, States have exercised this authority by providing tax preferences for in-State municipal bonds. Today more than 40 States provide such tax preferences. This Court's decision in *Bonaparte v. Tax Court*, 104 U.S. 592 (1881), indicated that such tax preferences are constitutionally permissible. Prior to the court of appeals' decision in this case, no court had ever held otherwise. The Court does not lightly declare such a long-established and widely accepted practice unconstitutional.

Congress has provided a federal tax exemption for municipal bonds since the inception of the federal income tax. Congress is well aware of the States' practice of exempting in-State municipal bonds from state taxation, and has taken no action to prohibit such exemptions. To the contrary, it has repeatedly approved interstate compacts that contemplate such preferences.

Declaring State tax preferences for in-State municipal bonds unconstitutional would harm State and local governments and upset the settled expectations of investors. State and local governments might be required to cut services, cancel projects, or raise taxes. Taxpayers who purchased out-of-State bonds expecting to pay taxes on the income would receive a windfall from the State Treasury if their taxes were retroactively refunded. And investors who purchased in-State bonds, accepting a lower interest rate in reliance upon the availability of a State tax exemption, would be harmed if the exemption were retroactively eliminated. Other important State

programs may also be placed at risk by an adverse ruling in this case.

2. When a State or local government enters the market the dormant Commerce Clause does not apply. The structuring, issuance, and sale of bonds constitutes direct market participation. Thus Kentucky and its public entities may favor their own citizens by offering them Kentucky bonds at a higher interest rate or a lower purchase price than they offer to other purchasers. Kentucky's tax exemption is economically equivalent to a higher interest rate for Kentucky taxpayers, and thus is constitutionally permissible. This Court's decisions holding that State tax exemptions benefiting private in-State businesses do not constitute direct market participation are inapplicable, because Kentucky's tax exemption benefits State and local government entities that directly participate in the market by issuing bonds.

3. Laws that treat in-State private business interests the same as out-of-State interests do not discriminate against interstate commerce for purposes of the dormant Commerce Clause. *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1797 (2007). Kentucky's tax exemption for in-State municipal bonds does not favor in-State private businesses at the expense of out-of-State businesses. Instead, it favors in-State government entities. The reasons for distinguishing between public and private entities, identified in *United Haulers*, apply with added force to the essential governmental function of issuing debt. Kentucky's tax exemption easily passes muster under the balancing test of *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970), because any burden on interstate commerce is clearly reasonable in relation to the local benefits derived from the exemption.

ARGUMENT

I. State Authority To Exempt In-State Municipal Bonds From State Taxation Is An Aspect Of The State's Sovereignty.

A. State Tax Exemptions For In-State Municipal Bonds Are A Longstanding And Widely-Accepted Exercise Of Sovereign Authority.

The authority of States to borrow money, like the authority to raise revenues through taxation, is a core aspect of State sovereignty. State and local governments must have access to capital markets in order to carry out their essential function of protecting and promoting the health, safety, and welfare of their citizens. By issuing municipal bonds, States and their political subdivisions are able to raise funds for costly projects that benefit State citizens over extended periods of time without having to depend entirely on tax revenues. In the absence of municipal bonds, many important State and local government initiatives would have to be delayed or cancelled.

Alexander Hamilton, perhaps the foremost authority on American public finance, observed that credit "is of the greatest consequence to every country." Alexander Hamilton, *Public Credit* in 2 The Works of Alexander Hamilton 294 (Henry Cabot Lodge ed. 1971) (1904). In *The Federalist*, Hamilton wrote that "individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants," and thus "an attempt by the national government to abridge [the States] in the exercise of [that authority] would be a violent assumption of power, unwarranted by any article or clause of its Constitution." *The Federalist* No. 32 (A. Hamilton). These principles

apply to revenues raised through public debt as well as through taxation.

Hamilton, who was the first Secretary of the U.S. Treasury and the architect of public credit for the new Nation, recognized that the issuance of public debt is an indispensable alternative to taxation as a means of raising government revenue. *See First Report on Public Credit* in 2 The Works of Alexander Hamilton, *supra* at 232 (describing "the great and invaluable ends to be secured by a proper and adequate provision, at the present period, for the support of public credit"). At Hamilton's urging, Congress assumed $25 million in State debt to achieve "an orderly, stable and satisfactory arrangement of the national finances." *Id.* at 244. Hamilton wrote that the "essence" of public debt is "promise," and asked, "Can the government rightfully tax its promise?" *Id.* at 284-85. He answered that it could not, reasoning that "[i]f the government had a right to tax its funds, the exercise of that right would cost much more than it was worth." *Id.* at 289.

In accordance with these principles, States have provided tax exemptions for in-State municipal bonds since the earliest days of State income taxes.[8] Today, 42 States provide preferential tax treatment for individual or corporate income earned on all or some in-State municipal bonds. *See* CCH 2007 State Tax Guide Charts ¶ 700-800, at 36,201-202.

Prior to the Kentucky Court of Appeals' decision in this case, *no* court had ever held that such tax preferences violate the dormant Commerce Clause. The shared understanding that State tax exemptions for municipal bonds are constitutional is supported by this Court's

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[8] *See, e.g.*, 1918 Mass. Acts 7; 1919 N.Y. Laws 1641-42.

decision in *Bonaparte v. Tax Court*, 104 U.S. 592 (1881). In *Bonaparte*, the Court addressed the question "whether the registered public debt of one State, exempt from taxation by the debtor State, or actually taxed there, is taxable by another State when owned by a resident of the latter State." *Id.* at 594. The Court held that it is. Although the Court's opinion specifically mentions the Full Faith and Credit Clause, it did not limit its holding to that Clause. To the contrary, it stated: "[W]e know of no provision of the Constitution of the United States which prohibits such taxation." *Id.* The Court held that a State "cannot secure such exemption [from taxation] *outside* of its own jurisdiction," without suggesting that an exemption *within* the State's jurisdiction is unconstitutional. *Id.* at 595 (emphasis added). The Court added, "While the Constitution . . . might have been so framed as to afford relief against such a disability, it has not been, and the States are left free to extend the comity which is sought, or not, as they please."[9] *Id.* Moreover, the taxpayer in *Bonaparte* made arguments based on Commerce Clause principles. *See* Plaintiff in Error Br. at 12 (States relinquished the right "to regulate, and even prohibit, commerce with their neighbors" in the Constitution, and therefore Maryland cannot "forbid subscriptions by its citizens to an Ohio or New York loan"); *id.* at 13 ("the people of New York or Pennsylvania would [not] have consented to forego their antecedent right to prohibit importations from Maryland, if they had understood that Maryland could still prohibit loans or sales to their governments"); *id.* at 17 (taxpayer's "two

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[9] The Articles of Confederation, unlike the Constitution, provided that "no imposition, duties or restriction shall be laid by any State on the property of the United States, or by either of them." Articles of Confederation art. IV, cl. 1.

main propositions" are that State taxation of its citizens' loans to other States (i) is "inconsistent with the mutual amity imposed on all the States by the Constitution" and (ii) violates the Full Faith and Credit Clause).

In the more than 125 years that separate this Court's decision in *Bonaparte* from the court of appeals' decision in this case, no court has held that State tax exemptions for municipal bonds are unconstitutional. Indeed, the issue was raised – and promptly rejected – in only one reported appellate case, *Shaper* v. *Tracy*, 647 N.E.2d 550, 553-54 (Ohio Ct. App. 1994). Given the importance of this issue, it undoubtedly would have been litigated more frequently if it had been regarded as doubtful.

The Court does not lightly declare such a long-established and widely accepted practice unconstitutional. *See, e.g., Walz v. Tax Comm'n of City of New York*, 397 U.S. 664, 678 (1970) (Although "no one acquires a vested or protected right in violation of the Constitution by long use, . . . an unbroken practice . . . is not something to be lightly cast aside."); *see also id.* at 681 (Brennan, J., concurring) ("The more longstanding and widely accepted a practice, the greater its impact upon constitutional interpretation."); *cf. Jackman v. Rosenbaum Co.*, 260 U.S. 22, 31 (1922) (Holmes, J.) ("If a thing has been practiced for two hundred years by common consent, it will need a strong case for the Fourteenth Amendment to affect it ...."). Here, it is the case for *upholding* Kentucky's tax exemption that is strong.

B. Congress Has Expressed Support For State Tax Exemptions For In-State Municipal Bonds.

Congress has provided a federal tax exemption for municipal bonds since the inception of the federal income

tax. *See* 26 U.S.C. §§ 103, 141-50. In 1976, Congress expanded the exemption, by allowing mutual funds to pass the exemption through to their shareholders.[10] Twice within the past decade, Congress has enacted legislation that recognizes the critical importance of State authority to borrow money by issuing bonds in times of crisis.[11]

Congress is well aware that many States have provided tax preferences for in-State municipal bonds.[12] Its acquiescence in this long-established and widespread practice indicates that Congress views it as consistent with constitutional requirements. *See General Motors Corp. v. Tracy*, 519 U.S. 278, 304-05 (1997) ("clear

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[10] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1930, codified as amended at 26 U.S.C. § 852(b)(5)(B). Congress has legislated with particularity in the field of municipal bonds. *See generally* 26 U.S.C. §§ 103, 141-50; *supra* note 4 (municipal bonds exempt from federal securities registration requirements). For example, Congress has established specific limits on the availability of the federal tax exemption for so-called "private activity" bonds. *See* 26 U.S.C. § 141. If Congress had intended to limit (let alone prohibit) State tax exemptions for in-State municipal bonds, it is likely to have enacted specific legislation to that effect.

[11] *See* Tax Benefits for Gulf Opportunity Zone, Pub. L. No. 109-135, 119 Stat. 2577 (2005), codified at 26 U.S.C. § 1400N(a)(1)(A) (following Hurricane Katrina); Tax Benefits for New York Liberty Zone, Pub. L. No. 107-147, 116 Stat. 2i (2002), codified at 26 U.S.C. § 1400L(d)(1) (following September 11 attacks).

[12] H.R. Rep. No. 88-1480, pt. 2, at 258-59 (1964) (listing States that exempt their own bonds from taxation, while taxing bonds of other States). *See also, e.g.*, H.R. Rep. No. 91-413 (1969) ("State and local governments generally do not directly tax the interest income on Federal bonds, but they tax the interest income on bonds issued by other States.").

indication" of fact that "Congress has done nothing to limit its unbroken recognition of the state regulatory authority" is that Congress views the States' actions as "well within the realm of what the States may reasonably promote and preserve") *cf. Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470, 493 (1974) ("Congress, by its silence over these many years, has seen the wisdom of allowing the States to enforce trade secret protection."). In addition, Congress has repeatedly approved interstate compacts under which public authorities such as the Port Authority of New York and New Jersey are authorized to issue municipal bonds that are exempt from taxation by the compacting States, even though those States tax income from other States' municipal bonds.[13]

Congress has expressed support for the tax-exempt status of municipal bonds, as well as the established practice of exempting in-State municipal bonds from State taxation. The dormant Commerce Clause should not be invoked to reach a contrary result.

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[13] *See, e.g.*, Port of New York Authority Compact, ch. 77, 42 Stat. 174 (1921); N.J. Stat. Ann. § 32:1-33; N.Y. Unconsol. Law § 6459; New Hampshire-Maine Interstate School Compact, Pub. L. No. 102-494, 106 Stat. 3153 (1992); Me. Rev. Stat. Ann. tit. 20-A, § 3647; N.H. Rev. Stat. Ann. § 200-F:1; Delaware-New Jersey Compact, Pub. L. No. 87-678, 76 Stat. 560 (1962); Del. Code Ann. tit. 17, § 1701; N.J. Stat. Ann. § 32:11E-1; Delaware River Joint Commission Compact, ch. 258, 47 Stat. 308 (1932); N.J. Stat. Ann. § 32:3-12; 36 Pa Cons. Stat. Ann. § 3503.

C. Declaring State Tax Exemptions For In-State Municipal Bonds Unconstitutional Would Harm The States And Defeat Investment-Backed Expectations.

If this Court were to declare Kentucky's tax exemption unconstitutional, it would cause significant disruption to municipal bond markets, as well as many State and local governments. State and local governments have issued municipal bonds in reliance upon the availability of State (and sometimes local) tax exemptions. In addition, States have assessed taxes and adopted budgets based on the expectation – supported by decades of unchallenged practice – that out-of-State bonds need not be granted the same exemption. If States were to grant a retroactive exemption to out-of-State bonds (which might be unavoidable if the State has made a contractual commitment that interest on in-State bonds will be exempt from State taxation), then States and their municipalities could face budget shortfalls that might necessitate reductions in government services, cancellation or delay of important government projects, or tax increases.

The expectations of municipal bond investors would also be upset by a holding that Kentucky's tax exemption is unconstitutional. Many investors have purchased in-State municipal bonds in reliance on the availability of a State tax exemption. These investors may have accepted a lower interest rate based on their expectation that interest would be exempt from State as well as federal taxes. If the State tax exemption is retroactively eliminated, the reasonable expectations of these investors will be defeated. Moreover, if the State tax exemption is eliminated for future years, the value of municipal bonds held by individual investors may fall significantly.

Similarly, investors such as Respondents purchased out-of-State bonds subject to the expectation that they

would be subject to taxation by Kentucky. Because these investors expected to pay State taxes, they may have demanded and received a higher interest rate as well as the benefits of greater diversification. If State taxes on out-of-State municipal bonds are retroactively eliminated, these investors will reap a windfall from the public fisc.

The effects of an adverse ruling in this case would likely extend beyond municipal bonds to other core State government activities. For example, many States sponsor College Savings Plans designed to assist their citizens in saving for their children's college education. Some States provide a tax exemption for State-sponsored plans, but not for plans sponsored by other States. If State tax exemptions for in-State municipal bonds violate the dormant Commerce Clause, then these exemptions for State-sponsored college savings plans may also be unconstitutional. Similarly, State tax exemptions for the pension income of retired State employees may be unconstitutional if the State does not provide a matching exemption to retired employees of other States. The dormant Commerce Clause should not be expanded to interfere with these core State financial programs.

II. The Principles Underlying The Market Participant Doctrine Confirm The Constitutionality Of Kentucky's Tax Exemption.

Although the Commerce Clause "does not in terms limit the power of States to regulate commerce," the Court has "long interpreted the Commerce Clause as an implicit restraint on state authority, even in the absence of a conflicting federal statute." *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1792 (2007). *But see id.* at 1798 (Scalia, J., concurring in part) (concluding that "the so-called 'negative' Commerce Clause is an unjustified judicial intervention"); *id.* at 1799 (Thomas, J., concurring in the judgment) (concluding that "[t]he negative Commerce

Clause has no basis in the Constitution"). The Court has repeatedly held, however, that "when a state or local government enters the market as a participant it is not subject to the restraints of the Commerce Clause." *White v. Massachusetts Council of Constr. Employers, Inc.*, 460 U.S. 204, 208 (1983). This "market participant doctrine" reflects the principle that "nothing in the purpose animating the Commerce Clause prohibits a State, in the absence of congressional action, from participating in the market and exercising the right to favor its own citizens over others." *Id.* at 207 (marks omitted). The doctrine embodies the Court's recognition that "[r]estraint in this area is also counseled by considerations of state sovereignty, the role of each State as guardian and trustee for its people." *Id.* at 207 n.3 (marks omitted).

The market participant doctrine applies when "the challenged program constitute[s] direct state participation in the market." *Reeves, Inc. v. Stake*, 447 U.S. 429, 435 n.7 (1980) (marks omitted). Thus, a State or local government acting as purchaser may choose to deal only with State or local residents, or with companies that employ a specified percentage of State or local residents. *See White*, 460 U.S. at 214-15 (upholding requirement that all construction projects funded in whole or part by funds controlled by the City of Boston must be performed by a workforce that includes at least 50 percent Boston residents). Similarly, a State acting as seller may choose to deal only with State residents. *See Reeves*, 447 U.S. at 446-47 (upholding South Dakota policy of selling cement from a State-owned plant only to residents of South Dakota). And a State may offer a subsidy that is limited to in-State purchasers. *See Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 809-10 (1976) (upholding a Maryland bounty for the destruction of automobile hulks that was available, as a practical matter, only to Maryland residents).

As the court of appeals recognized in this case, "No one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds." Pet. App. A10. The State or its political subdivisions are selling bonds and, in effect, "buying" the use of money. Whether viewed as a sale of bonds or a purchase of the use of money, the activity of Kentucky and its political subdivisions constitutes "direct state participation in the market" that triggers the application of the market participant doctrine.

It follows that Kentucky could choose to borrow money solely from its own citizens, and to sell bonds only to Kentucky citizens or taxpayers. *See White*, 460 U.S. at 214-15; *Reeves*, 447 U.S. at 436-40. Alternatively, Kentucky could choose to take the less drastic step of offering more favorable terms to in-State bond purchasers. *See Alexandria Scrap*, 426 U.S. at 809-10. These more favorable terms could take a variety of forms: a higher interest rate, a discounted purchase price, or a rebate for in-State purchasers.

Kentucky's tax exemption is economically equivalent to paying a higher interest rate to Kentucky taxpayers, or granting them a discount or rebate on the purchase price. By the same token, the lower interest rate accepted by Kentucky taxpayers in return for the tax exemption may be viewed as a form of implicit taxation. *See* Avishai Shachar, *From Income to Consumption Tax: Criteria for Rules of Transition*, 97 Harv. L. Rev. 1581, 1596 n.60 (1984) ("The lower rate of interest received on tax-exempt bonds relative to the rate of interest received on taxable bonds is an implicit tax on holders of tax-exempt bonds").[14] Given that it is constitutional for Kentucky to

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[14] Alexander Hamilton recognized that a borrower, "[r]elying upon the engagement of the government, express or implied, that he will receive (continued...)

grant its own taxpayers a discount or pay them additional interest, it makes no sense to hold that it is unconstitutional to provide an equivalent benefit in the form of a tax exemption.[15]

In establishing a tax preference for in-State municipal bonds, Kentucky was establishing the terms on which it borrows. Few if any State actions are closer to the core of State sovereignty. Respondents rely on decisions of this Court holding, in particular circumstances, that State tax exemptions for *private* businesses fall outside the boundaries of the market participant doctrine. Those decisions are readily distinguishable and should not be expanded to cover this case.

In *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 277 (1988), the Court held that the market participant doctrine did not apply to an Ohio tax exemption for ethanol produced by (i) Ohio producers and (ii) out-of-State producers in States that offered a reciprocal tax exemption to Ohio ethanol producers. The Court recognized that a tax credit scheme may have the

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what is promised him, without defalcation . . . is content with a less interest. . . . In this lower rate of interest he may be truly said to pay his tax or to purchase an exemption from it." 2 The Works of Alexander Hamilton, *supra* at 288.

[15] This case may be analogized to *White*. In *White*, the Court held that a State or local government may choose to do business only with contractors that hire State or city residents. *See* 460 U.S. at 214-15. Here, States are effectively "hiring" the use of money by issuing bonds, and thus may choose to give a preference to their own citizens. *See* Scott K. Attaway, Note, *The Case for Constitutional Discrimination In Taxation Of Out-Of-State Municipal Bonds*, 76 B.U. L. Rev. 737, 764 (1996).

purpose and effect of subsidizing a particular industry, but held that this equivalence "does not transform [the tax exemption] into a form of state participation in the free market." *Id.* at 277. The Court concluded that taxation is action "*in connection with the State's regulation of interstate commerce.*" *Id.* at 278 (emphasis in original).

In *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 589 (1997), the Court held that the market participant doctrine did not apply to a Maine tax exemption for charitable organizations that primarily serve State residents. As in *Limbach*, the Court assumed that a direct subsidy to in-state businesses or charities may be constitutional, but held that a tax exemption is not. *Id.* at 589. The Court's opinion includes the broad statements that "a tax exemption statute cannot be characterized as proprietary activity falling within the market participant exception" and "[a] tax exemption is not the sort of direct state involvement in the market that falls within the market-participation doctrine." *Id.* at 593.[16]

This case is readily distinguishable from decisions such as *Limbach* and *Camps Newfound/Owatonna*. In those cases, the State granted a tax exemption to private

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[16] In *Camps Newfound/Owatonna*, the Court cited *Walz v. Tax Comm'n of City of New York*, 397 U.S. 664 (1970), as support for the proposition that there is a "constitutionally significant difference between subsidies and tax exemptions." 520 U.S. at 590. *Walz* was an Establishment Clause case; the basis for the distinction between subsidies and tax exemptions in *Walz* was that subsidies entail greater government entanglement in the activities of religious entities. 397 U.S. at 690-91. Because "entanglement" is not an element of Commerce Clause analysis, the basis for the distinction in *Walz* does not apply to this case.

entities, and the Court concluded that a tax exemption cannot be viewed as direct State participation in the market. In this case, in contrast, Kentucky's tax exemption does not benefit private entities, but instead benefits State and local government entities that are directly participating in the market. Because Kentucky and its public issuers are direct market participants, the State has broad authority to favor in-State residents in its own commercial dealings. In these circumstances, a tax exemption does not raise the same constitutional concerns as a tax exemption that benefits private businesses. As the Court observed in *Reeves*, the State's action can be described as "'protectionist' only in the sense that it limits benefits generated by a state program to those who fund the state treasury and whom the State was created to serve." 447 U.S. at 442.

As noted above, p. 20, the State could achieve exactly the same result by offering in-State purchasers of municipal bonds a higher interest rate or rebate in lieu of a tax exemption. If Kentucky sold bonds to a citizen who owed a debt to the State (*e.g.*, an unpaid fine, a judgment in a civil case, or unpaid taxes), it is difficult to see why the dormant Commerce Clause would prevent the State from offsetting the debt against the rebate on the municipal bonds.

The Court generally refuses to draw constitutional lines based on formalistic distinctions that lack economic substance. *See, e.g., West Lynn Creamery, Inc., v. Healy*, 512 U.S. 186, 201 (1994) ("[O]ur cases have eschewed formalism for a sensitive, case-by-case analysis of purposes and effects."); *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 99 n.11 (1984) ("It is the substance of the transaction, rather than the label attached to it, that governs Commerce Clause analysis."). In *Regan v. Taxation With Representation of Washington*, 461 U.S. 540, 544-46 (1983), the Court recognized that "[b]oth tax exemptions and tax deductibility are a form of

subsidy," and treated Congress's decision to withhold tax-exempt status from organizations that engage in substantial lobbying as constitutionally equivalent to a (permissible) subsidy to organizations that refrain from lobbying.

In short, Kentucky and its political subdivisions participate directly in the market by borrowing money and issuing bonds. A tax exemption is one of many ways in which State and local governments are free to favor their own citizens when they enter the market, and thus it should not be prohibited under the dormant Commerce Clause. This Court's cases holding that a tax exemption for private in-State businesses falls outside the market participant doctrine are inapposite.

III. Kentucky's Tax Exemption For In-State Municipal Bonds Is Constitutional Because It Treats All Private Businesses The Same.

A. Laws That Treat All Private Businesses The Same Do Not Discriminate Against Interstate Commerce For Commerce Clause Purposes.

In construing the "dormant" aspect of the Commerce Clause, the Court has recognized that "[r]estraint in this area is . . . counseled by considerations of state sovereignty, the role of each State as guardian and trustee for its people." *White*, 460 U.S. at 207 n.3 (marks omitted). Considerations of State sovereignty play a central role in this case.

To determine whether a law violates the "so-called 'dormant' aspect of the Commerce Clause," the Court first asks "whether it discriminates on its face against interstate commerce." *United Haulers*, 127 S. Ct. at 1793. "Discriminatory laws motivated by 'simple economic protectionism' are subject to a 'virtually *per se* rule of invalidity'"; nondiscriminatory laws are valid "unless the

burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits." *Id.* at 1793, 1797, quoting *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970).[17]

In *United Haulers*, the Court held that State and local laws "which treat in-state private business interests exactly the same as out-of-state ones, do not 'discriminate against interstate commerce' for purposes of the dormant Commerce Clause." 127 S. Ct. at 1797. *United Haulers* upheld the validity of "flow control" ordinances that require trash haulers to deliver solid waste to a government-owned waste processing facility. *Id.* at 1790. The Court recognized that it had invalidated a "quite similar" ordinance in *C & A Carbone, Inc. v. Clarkstown*, 511 U.S. 383 (1994). 127 S. Ct. at 1790. Indeed, the Court observed, "[t]he only salient difference" between the two cases was that the ordinance in *Carbone* involved a private waste processing facility, while the ordinances in *United Haulers* "require haulers to bring waste to facilities owned and operated by a state-created public benefit corporation." *Id.* The Court held that the difference between public and private entities is "constitutionally significant." *Id.*

The Court found that there are "[c]ompelling reasons" to "treat[ ] laws [that favor a public entity] differently from laws favoring particular private businesses over their competitors." *Id.* at 1795. *First*, discrimination

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[17] State taxes are permissible under the Commerce Clause so long as they (i) are sufficiently connected to the State to justify a tax, (ii) are fairly related to benefits provided to the taxpayer, (iii) do not discriminate against interstate commerce, and (iv) are fairly apportioned. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 287 (1977). The only requirement at issue here is the non-discrimination requirement.

"assumes a comparison of substantially similar entities." *Id.* (marks omitted). Public entities are not substantially similar to private entities, because only public entities are "vested with the responsibility of protecting the health, safety, and welfare of [their] citizens." *Id. Second*, "it does not make sense to regard laws favoring local government and laws favoring private industry with equal skepticism." *Id.* "When a law favors in-state business over out-of-state competition, rigorous scrutiny is appropriate because the law is often the product of 'simple economic protectionism.'" *Id.* at 1795-96, quoting *Wyoming* v. *Oklahoma*, 502 U.S. 437, 454 (1992). In contrast, laws favoring local government "may be directed toward any number of legitimate goals unrelated to protectionism." 127 S. Ct. at 1796. *Third*, treating public and private entities the same under the dormant Commerce Clause "would lead to unprecedented and unbounded interference by the courts with state and local government." *Id.* The Court observed that "the dormant Commerce Clause is not a roving license for federal courts to decide what activities are appropriate for state and local government to undertake, and what activities must be the province of private market competition." *Id. Fourth*, federal courts should hesitate to interfere with laws concerning a "typical and traditional" local government function, particularly when "Congress itself has recognized local government's vital role" in the activity at issue. *Id. Fifth*, "the most palpable harm imposed" by the laws "is likely to fall upon the very people who voted for the laws." *Id.* at 1797.

B. Kentucky's Tax Exemption Does Not Favor In-State Private Businesses Over Out-Of-State Businesses, And Thus Does Not Discriminate Against Interstate Commerce.

The Court's decision in *United Haulers* strongly supports the conclusion that Kentucky's tax exemption for in-State bonds is constitutionally permissible. Kentucky

provides a tax exemption for municipal bonds issued by State and local government entities, not private businesses. Because Kentucky's law does not favor in-State private business at the expense of out-of-State businesses, it does not discriminate against interstate commerce for purposes of the dormant Commerce Clause.

. . The reasons the Court identified for its decision in *United Haulers* are equally if not more compelling in this case. Kentucky and its political subdivisions, unlike private entities, are responsible for furthering the health, safety, and welfare of Kentucky's citizens. Kentucky's tax exemption for in-State municipal bonds furthers legitimate goals unrelated to protectionism. The tax exemption facilitates the borrowing of funds by the Commonwealth and its political subdivisions to support important government programs and projects. The State tax exemption supports State and local programs, just as the federal government supports such programs by exempting municipal bonds from federal taxation. By providing Kentucky citizens with an additional incentive to purchase Kentucky bonds, the Commonwealth may increase the participation of its own citizens in its financial affairs. Such participation may lead to a more informed electorate, provide an additional check on State and local government, and attract investors who are better informed and more committed to the projects funded with their money.

Treating municipal bonds the same as privately-issued bonds would lead to "unprecedented and unbounded" interference with State and local government. States have been granted wide latitude to borrow money from their own citizens on terms set by the State and agreed to by investors. As described above, pp. 17-18, declaring State tax exemptions for municipal bonds unconstitutional at this late date would cause significant disruption to the municipal bond market and to State and local governments.

Moreover, the issuance of municipal bonds is a typical and traditional local government function. If anything, the power to raise revenues by borrowing money is an even more "typical and traditional" State function than the power to dispose of waste. And as noted above, pp. 15-16, Congress has recognized the importance of tax-exempt municipal bonds and given the States wide leeway in this area.

As in *United Haulers*, the most palpable harm from Kentucky's tax exemption is likely to fall upon the very people who voted for the laws. The availability of an exemption from Kentucky's income tax is primarily of concern to Kentucky taxpayers. Kentucky's taxpayers – including those who do not purchase in-State municipal bonds – have a built-in incentive to oppose excessive tax exemptions, which reduce tax revenues and must be balanced by tax revenues from other sources.

Other States have not complained that they are harmed by Kentucky's law. To the contrary, an overwhelming majority of States has enacted tax exemptions like Kentucky's. These exemptions tend to offset any loss of municipal bond sales to Kentucky taxpayers by *increasing* sales to in-State taxpayers.

In sum, the principles recognized by this Court in *United Haulers* strongly support the conclusion that Kentucky's tax exemption does not discriminate against interstate commerce. Indeed, this case is easier than *United Haulers* in at least one significant respect: In *United Haulers*, the local ordinances at issue completely excluded out-of-state competitors by requiring all waste to be sent to a government-owned facility. Here, Kentucky has not required Kentucky taxpayers to buy only Kentucky bonds. Instead, it has provided an incentive, in the form of a tax exemption, for Kentucky taxpayers who purchase bonds issued by the Commonwealth and its issuing entities. An incentive to purchase bonds issued by

a public agency is not "discrimination" against interstate commerce for purposes of the dormant Commerce Clause.

C. The Laws At Issue Are Valid Under The *Pike* Balancing Test.

The plurality in *United Haulers* concluded that State and local laws that treat all private businesses the same "are properly analyzed under the test set forth in *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970)." 127 S. Ct. at 1797. Under that test, the Court will uphold the law at issue "'unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.'" *Id.*, quoting *Pike*, 397 U.S. at 142. Assuming that test applies to tax exemptions, Kentucky's exemption for in-State municipal bonds passes easily.

Here, as in *United Haulers*, there is no indication that Kentucky's tax exemption has any disparate impact on out-of-State businesses as opposed to in-State businesses. Kentucky taxpayers are taxed on interest income from bonds issued by corporations and other private entities whether they are issued by Kentucky businesses or out-of-State businesses.

To the extent Kentucky's tax exemption imposes any burden on interstate commerce, it is not excessive in relation to the public benefits of Kentucky's tax exemption. The exemption makes it possible for Kentucky and its public issuers to borrow funds to finance government initiatives at a lower interest rate, while providing an incentive to the State's own citizens to participate in financing such initiatives. Accordingly, Kentucky's tax exemption easily survives *Pike* analysis.

CONCLUSION

The court of appeals' decision should be reversed.

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IN THE

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Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS
Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF FOR THE NATIONAL FEDERATION OF MUNICIPAL ANALYSTS, AS *AMICUS CURIAE* IN SUPPORT OF NEITHER PARTY

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INTERESTS OF *AMICUS CURIAE* [1]

The National Federation of Municipal Analysts ("NFMA") is a not-for-profit association of over 1,000 members, primarily research analysts, who evaluate credit and other associated risks in the state and local municipal bond market. These individuals represent, among other entities, mutual

[1] In accordance with Supreme Court Rule 37.6, the NFMA states that this brief was authored in its entirety by the counsel listed on the cover and that counsel to a party did not author this brief in whole or in part. No person or entity other than the *amicus curiae* and its counsel made a monetary contribution to the preparation or submission of this brief.

funds, insurance companies, broker/dealers, bond insurers, rating agencies and financial advisory firms. The NFMA was established in 1983 to promote professionalism in municipal credit analysis and further the skill level of its members through educational programs and industry communication. The NFMA furthers this goal by providing informed perspective regarding legal and regulatory matters relating to the municipal finance industry, and facilitating the flow of information between investors and issuing entities. The NFMA includes six constituent societies: (1) the Boston Municipal Analysts Forum; (2) the California Society of Municipal Analysts; (3) the Chicago Municipal Analysts Society; (4) the Minnesota Society of Municipal Analysts; (5) the Municipal Analysts Group of New York; and (6) the Southern Municipal Finance Society, as well as members unaffiliated with such societies.

The Respondents challenge long-standing state tax policies around which the existing system for financing the public expenditures of states, cities, towns and other public entities has developed. An affirmance in this case would require changes to the tax policies and laws of at least 42 states and would generate potentially prolonged legal and market uncertainty, thereby weakening the stability of the municipal bond market. The NFMA, as an organization dedicated to the existence of a sound municipal bond market, and its members, who are actively involved in the functioning of that market, have a substantial interest in ensuring that the consequences of such a profound change to the state tax treatment of municipal bonds be articulated to and understood by the Court as it evaluates the Respondents' challenge. In addition to providing context for the issue before the Court, the NFMA seeks to provide information about the benefits and burdens of the challenged state taxation practice that may be relevant should the Court determine that a "balancing test" approach should be applied to resolving the constitutional question presented.

SUMMARY

The NFMA does not offer an opinion in this brief concerning the central legal issue of this case, *i.e.*, whether Kentucky's exemption from its income tax of interest earned on municipal bonds issued in Kentucky violates the "dormant" aspect of the Commerce Clause because the same exemption is not granted by Kentucky to municipal bonds issued in other states. Instead, the NFMA submits this brief, in support of neither party[2], with the primary objective of providing the Court with information concerning the structure of the municipal bond market in general and municipal bond mutual funds in particular and the potential effects on such market of an affirmance of the Kentucky appellate court's decision.

Specific financial projections regarding the potential impact on any particular municipal issuers, or categories of municipal issuers, of a ruling by the Court affirming the lower Kentucky court would need to be based on a host of assumptions about the interaction of numerous factors that determine the ultimate borrowing cost for a particular municipal bond issue at a particular time. This brief instead explains in general terms how such a ruling would affect the tax-exempt bond market and, in particular, potentially realign borrowing costs for some of the larger municipal issuers while adversely affecting borrowing costs and/or market access for smaller municipal issuers.

ARGUMENT

I. THE EXISTING MUNICIPAL BOND MARKET.

A. Types of Municipal Bonds.

The municipal bond market is a market of great complexity, variety and importance with one central attribute: the

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[2] Pursuant to Supreme Court Rule 37.3(a), counsel of record for both Petitioners and Respondents have consented to the filing of amicus briefs, including this brief, in letters that have been lodged with the clerk.

products offered in the market—municipal bonds—are generated solely by the public sector, namely the state and local governmental issuers that issue and sell such bonds in order to finance expenditures that address public needs. As described below, there are various categories and subcategories of municipal bonds, with attributes that vary significantly, but having in common the public nature of the bond issuers and the public purposes sought to be advanced by their capital-raising.

1. *General Obligation and Revenue Bonds.*

The vast majority by number and dollar amount of municipal bonds are federally tax-exempt bonds issued by states, cities, towns, counties and districts, or by public authorities issuing on their behalf, to finance long-term public capital expenditures, including the acquisition of public lands and the construction and improvement of public buildings and of transportation, water and sewer systems and other infrastructure. Such bonds are issued as "general obligation bonds" payable from the full faith and credit of the governmental issuer (*e.g.*, taxes and all other moneys available to the issuer for the repayment of the debt incurred), or, in the case of municipal bonds issued to finance facilities that generate sufficient revenues to repay the applicable debt, as "revenue bonds" payable solely from the fees, tolls and other charges paid by the users of the applicable facilities. In 2006, approximately $387 billion in long-term bonds were issued, of which approximately $115 billion were general obligation bonds and approximately $272 billion were revenue bonds. *See* Securities Industry and Financial Markets Association (SIFMA), *Municipal Bond Credit Report*, March 2007, *available at* archives1.sifma.org/assets/files/Municipal_Credit_Report_06Q4.pdf.

There are numerous variations on the prototypical general obligation or revenue bond issued to finance bridges, roads, schools, libraries, police stations, fire stations, public housing,

health care facilities, parks and the like. Such variations include "double-barreled bonds" payable from a dedicated revenue stream and backed by the general obligation of the issuing jurisdiction; "dedicated tax" bonds with first priority vis-à-vis other municipal bonds against certain portions of sales taxes or other specialized taxes collected by the issuer; "moral obligation" bonds backed by a non-binding statement of legislative intent to appropriate funds if required to pay debt service; tax anticipation notes, revenue anticipation notes, deficit bonds and other types of bonds issued not to fund capital expenditures but to provide short-term or permanent financing of a governmental entity's operating expenses (such as the salaries and other compensation of public sector employees); and refunding bonds, issued to lower interest costs, extend repayment periods and/or change other terms associated with previously issued municipal bonds.

2. *Federally Tax-Exempt and Federally Taxable Municipal Bonds.*

Most general obligation or revenue bonds qualify for federal tax-exemption, *i.e.*, the interest on the bonds is exempted from federal income tax payable by the holder of the bonds, thereby permitting the issuer of the bonds to pay a lower interest rate that from the bond purchaser's perspective is competitive on an after-tax basis with a federally taxable debt instrument bearing a higher interest rate. Federal tax-exemption, however, is not an inherent characteristic of a municipal bond. The Internal Revenue Code does not provide federal tax-exemption for all municipal bonds issued to finance the public needs of state and local governments. For example, municipal bonds issued to finance multi-billion dollar unfunded deficits in future pension obligations of a state or city to its public employees do not qualify for federal tax-exemption, and are issued as federally taxable but generally state tax-exempt municipal bonds. This Court has held that federal tax-exemption of municipal bonds is not mandated by

the U.S. Constitution, *see South Carolina v. Baker*, 485 U.S. 505 (1988), but rather is a legislative decision for the federal government, and accordingly the financing needs of state and local government municipal bond issuers and federal tax-exemption of municipal bonds are not now, and are not inherently, co-extensive.

3. *Conduit Bonds.*

A subcategory of revenue bonds consists of so-called "conduit" municipal bonds, which constitute a minority by dollar amount of revenue bond issues, and a smaller minority by dollar amount of all municipal bond issues, but nonetheless a meaningful component of the municipal bond market. Such municipal bonds are issued to provide governmental financing to non-governmental entities or persons conducting activities that the state legislature has determined serve a public purpose. Such municipal bonds frequently qualify for federal tax-exemption and, irrespective of federal tax-exemption, typically—though not always—qualify for state tax-exemption. The facilities or activities financed by conduit municipal bonds—which also are referred to as industrial revenue bonds, industrial development bonds or private activity bonds—include federally-insured or state-authorized student loans for higher education; low-income or mixed-income housing; hospitals, nursing homes, assisted living and other health care facilities; schools, colleges and universities; museums; social services agencies; solid waste disposal facilities; airports; docks and wharves; mass commuting facilities; sewage facilities; facilities for the furnishing of water or the local furnishing of electric energy or gas; local district heating or cooling facilities; hazardous waste facilities; high-speed intercity rail facilities; environmental enhancements of hydroelectric generating facilities; small manufacturing facilities and so-called "Liberty Bonds" issued to rebuild the areas devastated by the 9/11 terrorist attacks. State law may require that the public issuers of conduit bonds own the

financed facilities for the duration of the bonds, but permit leasing of the financed facilities to the non-governmental user of the facility under terms that require that the lessee pay the debt service on the applicable municipal bonds. Federal tax-exemption statutes likewise require that certain facilities financed by such conduit municipal bonds—such as airports, docks and wharves, mass commuting facilities and environmental enhancements of hydroelectric generating facilities—be owned by state or local government for at least the duration of the bonds, while permitting leases to non-governmental users for portions of the useful life of the financed facility. In those instances where neither state nor federal law requires that the financed facility be governmentally owned, conduit bonds may be structured in a manner that the governmental issuer loans the proceeds of the municipal bonds to a non-governmental entity for construction of the financed facility and use of such facility for the legislatively approved public purpose.[3]

4. *Tax Credit Bonds.*

Yet another variation on the theme is provided by tax credit bonds, which do not benefit from federal interest tax-exemption, but instead provide the bondholder with federal tax credits that can be applied to reduce the bondholder's federal tax liability. Such municipal bonds, which include "qualified zone academy bonds", "clean renewable energy bonds" and "Gulf tax credit bonds" (to finance the rebuilding of hurricane-devastated areas), are in some instances state tax-exempt.

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[3] In the case of conduit municipal bonds, whether the financed facility is owned by the public issuer or a non-governmental entity, the debt service on the bonds generally is payable by the public issuer solely from the lease payments, loan payments or other revenues received from the non-governmental user of the financed asset, and not from any taxes or other public moneys.

B. Borrowing Cost Advantages Provided by Tax-Exemption.

State tax-exemption of municipal bonds generally entails exemption of interest income from state income taxes as well as any otherwise applicable local income taxes, and for certain issuers may also entail exemption from certain other state taxes, such as income taxes on capital gains or certain franchise or estate taxes. The borrowing cost advantage provided by state tax-exemption, which, in the case of federally tax-exempt bonds, is incremental to the cost advantage provided by federal tax-exemption[4] and, in the case of federally taxable but state tax-exempt municipal bonds, is the primary borrowing cost advantage, is influenced by factors such as then effective state (and, if applicable, local) income tax rates, the creditworthiness of the applicable municipal bond, the length of time it will be outstanding, and supply and demand elements. All other things being equal, the higher the state and local taxes otherwise applicable to the bond purchaser[5],

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[4] The extent to which federal tax-exemption lowers the otherwise applicable interest rate on municipal bonds varies depending on a number of factors, such as then effective federal income tax rates, the creditworthiness of the applicable municipal bond, the length of time it will be outstanding, and supply and demand elements. For example, at the end of 2006, the borrowing costs on AAA-rated, 10-year municipal bonds on average were 80.3 percent of comparable, but federally taxable, U.S. Treasury securities, whereas at the end of 2005 the borrowing costs on such municipal bonds were 88.4 percent of comparable U.S. Treasury bonds. *See* Securities Industry and Financial Markets Association, *Municipal Bond Credit Report*, March 2007, at 2, *available at* archives1.sifma.org/assets/files/Municipal Credit Report 06Q4.pdf.

[5] Sample high income tax states include New York (7.7% maximum personal state income tax rate for 2006, plus, for New York City taxpayers, 3.648% maximum local income tax rate for 2006); California (9.3% maximum personal state income tax rate for 2006), New Jersey (8.97% maximum personal state income tax rate for 2006), North Carolina (8.25% maximum personal state income tax rate for 2006) and Ohio (7.25% maximum personal state income tax rate for 2006).

the more valuable to that bond purchaser the state tax-exemption becomes, and the larger the reduction in borrowing costs to the municipal bond issuer is as a result of the state tax-exemption; in lower or no income tax states, the reduction in borrowing rates resulting from the state tax-exemption is lower or non-existent. The amount by which borrowing costs are reduced in high tax states as a result of the combination of state tax-exemption for in-state municipal bonds and lack of exemption for out-of-state municipal varies over time, but is appreciable.[6]

The reduction in borrowing costs attributable to state tax-exemption of municipal bond interest is not fully commensurate with the potential state tax savings to purchasers of such bonds. Demand for bonds issued in a specific state from taxpayers within such state may not be sufficient to absorb all bond issues by such state's issuers or all bonds within particular bond issues. Accordingly, purchasers of bonds that are exempt from state income taxes in the issuing state may include taxpayers from other states that do not exempt such interest income, or that do exempt such interest income but have lower state income tax rates than the state in which the bond is issued. As noted below, a substantial portion of municipal bond issues that cannot be absorbed exclusively by purchasers within the issuing state, or by single-state mutual funds dedicated to purchasing bonds of the issuing state, are purchased by national municipal bond mutual funds and by other investors that are indifferent to the state tax exemption

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[6] Per the calculations of the trading desk at the Eaton Vance mutual fund complex, as of July 16, 2007, annual yields on municipal bonds issued in New Jersey, New York and California were 0.20% (20 basis points), 0.12% (12 basis points) and 0.08% (8 basis points), respectively, lower relative to the Thomson Municipal Market Data (MMD) benchmark for the tax-exempt municipal bond market than yields on comparably credit-worthy bonds issued in states with relatively low state income taxes.

or that are induced to purchase by an attractive interest rate. The reduced (or nonexistent) state tax benefit to out-of-state purchasers is reflected in their demand for, and the interest rate payable on, the applicable municipal bonds.

C. Purchasers of Municipal Bonds.

Municipal bonds are purchased and held by individual investors, investment companies, insurance companies, commercial banks and other institutional investors. The following data provide a profile of the market as it exists today:

- As of the end of 2006, approximately $2.4 trillion in tax-exempt municipal bonds were outstanding. Ownership broke down as follows:
    - Individuals owned approximately $865 billion;
    - Investment companies owned approximately $802 billion;
    - Insurance companies owned approximately $364 billion;
    - Commercial banks and broker-dealers owned approximately $242 billion; and
    - Other institutional investors owned approximately $129 billion. *See* Securities Industry and Financial Markets Association, *Holders of Municipal Bond Securities*, available at www.sifma.org/research/pdf/Holders_Municipal_Securities.pdf.
- After individuals, the second largest category of holders of tax-exempt debt in the United States is registered investment companies, including mutual funds, unit investment trusts, closed-end funds and exchange-traded funds. *See* Investment Company Institute, *2007 Investment Company Fact Book*, at 10, *available at* www.ici.org/home/2007_factbook.

pdf. In 2006, over a third of all municipal bonds issued in the United States were purchased and held by mutual funds and other registered investment companies. *Id.*

- In 2006, tax-exempt mutual funds held approximately $365 billion in long-term bonds, of which approximately $155 billion were held in 481 single-state funds and approximately $210 billion in 230 national funds. *Id.* at table 4, p. 96, and table 6, p. 98.

- As of March 31, 2007, tax-exempt money market funds (a subcategory of mutual funds) held approximately $379 billion in short-term municipal bonds (including tax-exempt commercial paper, short-term notes, variable rate long-term bonds with put features and synthetic short-term notes with put features derived from long-term bonds). Of this amount, approximately $254 billion were held in national tax-exempt money market funds and approximately $125 billion in single state tax-exempt money market funds. *See* Lipper Analytical Services, *Tax-Exempt Fixed Income Fund Performance Analysis,* 1st Quarter 2007 Report.

- Municipal bond holdings in mutual funds were held through approximately 1,647,000 shareholder accounts in single-state long-term bond funds, approximately 2,527,000 shareholder accounts in national long-term bond funds and approximately 3,061,000 tax-exempt money market fund shareholder accounts. *See* Investment Company Institute, *2007 Investment Company Fact Book*, at table 10, p. 102, *available at* www.ici.org/home/2007_factbook.pdf.

- In addition, approximately $95 billion of municipal bonds were held in 276 closed-end municipal bond funds, and approximately $8.7 billion of municipal

bonds were held in tax-exempt unit investment trusts. *Id.* at tables 11 and 13, pp. 103 and 105.

Because mutual funds are structured in a manner that permits ready identification of funds that buy only municipal bonds of a specific state versus funds that buy municipal bonds on a national basis, they provide the most reliable readily available data on the extent to which the currently prevailing state tax system drives bond purchasers to purchase bonds of a particular state. Based on the above-described recent data, approximately 42% of long-term municipal bonds owned by mutual funds, and approximately 33% of short-term municipal securities owned by money market funds, are owned by funds that target taxpayers of the state in which the bond issuer is located, and approximately 58% of such long-term municipal bonds and approximately 67% of such short-term municipal securities were purchased without regard to a match between the state of the bond issuer and the state of the fund's shareholders.

These percentages indicate that the national market is the predominant market for municipal bonds as a whole, but that there is a substantial and influential sector of municipal bond purchasers that generally will only purchase municipal bonds issued in a specific state. Similar statistics for municipal bonds purchased directly by individuals or other non mutual fund investors are difficult to obtain, but it is unlikely that direct purchaser trends would deviate substantially from those applicable to mutual fund and money market fund shareholders.

D. National and Single State Tax-Exempt Municipal Bond Funds.

The current municipal bond marketplace is in part a national market and in part a state by state market. National tax-exempt municipal bond funds, as their label suggests, are permitted to purchase federally tax-exempt municipal bonds

issued in any state. They generally have substantially larger amounts of assets under management, and offer greater diversification, including geographic diversification, in their municipal bond portfolios, than do single state funds, and state tax-exemption plays no appreciable role in their selection of municipal bonds for their investment portfolios or in their shareholders' decision to invest in such funds.[7]

Single state tax-exempt municipal bond funds are required to invest substantially all their invested assets in bonds issued within the applicable state. Because of their sharply reduced geographic diversification and somewhat higher expense ratios relative to national funds (because the fund's fixed expenses generally are spread over a smaller asset base), single state funds appeal primarily to investors seeking to maximize their tax-exempt return by investing in a fund that will produce income that is not only federally tax-exempt but also state tax-exempt and, where applicable, locally tax-exempt (so-called "triple tax-exempt"). Accordingly, shareholders in single state funds almost invariably are taxpayers in the state to which the fund's portfolio investments are dedicated.

The formation and maintenance of single state funds, as well as their number and size, is driven by market demand. Single state funds currently exist for 42 states. *See* Lipper Analytical Services, *Tax-Exempt Fixed Income Fund Per-*

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[7] National tax-exempt municipal bond funds report to their shareholders for tax purposes the percentage of the applicable fund's annual income derived from bonds issued in each state, and shareholders can use such information to avoid state income tax payments on a prorated portion of tax-exempt interest income received from such funds, to the extent the states in which they pay taxes provide an exemption for municipal bond interest derived from bonds issued in the applicable states. However, because shareholders have no assurance that any particular percentage of a national fund's assets will be invested in any particular state's municipal bonds, such state tax-exemption generally is not a factor in their decisions to invest in a national fund.

formance Analysis, 1st Quarter 2007 Report. The following is a profile of the states for which no single state funds have been established, and of those for which such funds exist:

- The eight states that lack representation in the single state fund market are Alaska, Illinois, Indiana, Iowa, Nevada, South Dakota, Texas, and Wyoming.
- Five of these eight states lack a state income tax: Alaska, Nevada, South Dakota, Texas and Wyoming.
- Indiana has a state income tax, but exempts municipal bonds irrespective of whether the issuer is located in Indiana or in a sister state. Ind. Code An. § 6-3-1-3.5 (2007).
- The remaining two of these eight states, Illinois and Iowa, apply their state income tax to municipal bonds irrespective of whether the issuer is located within the state or in a sister state, with the exception of an exemption for a discrete number of in-state issuers. *See* Iowa Code § 12.91 (2007); 20 Ill. Comp. Stat. Ann. 3501/820-60 (2007).

Accordingly, there is almost total overlap between the states for which single state funds have been formed and the states that exempt from their state income taxes only municipal bonds issued within their borders. There is one exception: single state funds have been established for Florida, which has no state income tax. This exception reflects one instance where shareholder affinity to municipal issuers in their "backyard" has provided a sufficient basis for the marketing and viability of funds dedicated to a specific state's municipal bond offerings, but proves the general rule that single state funds are almost entirely a creation of the prevalent state income tax treatment of exempting income earned on in-state municipal bonds while taxing income earned on out-of-state municipal bonds.

National mutual funds generally have more assets to invest and a much wider variety of issuers to select from, and therefore are less likely to dedicate the time necessary to evaluate a small, obscure or infrequent municipal bond issuer or to purchase bonds issued by such public entities.

Single state funds, by contrast, are likely to sift through most if not all municipal bond issuers within the specific states to which they are dedicated and to familiarize themselves with, and purchase municipal bonds of, a broader range of municipal issuers within the state, including smaller, lesser-known and lower-rated issuers. Because a single state fund is required to invest substantially all of its assets in municipal bonds issued in one specific state, the analysts and portfolio managers assigned to a single state fund focus on the full spectrum of municipal bond issuers of the applicable state in a manner that analysts and portfolio managers of national mutual funds do not.

The large bond issues by well-known state-level issuers that are most readily purchased by national mutual funds constitute the largest proportion of the tax-exempt bond market by volume, but are only a small minority of the municipal bond market by number of bond issues. According to statistics compiled by the Internal Revenue Service, in 2002 almost 50 percent of the total number of new money long term municipal bonds issued to finance governmental assets had a bond issue size of less than $1,000,000, and were issued by smaller towns to finance school buses, fire trucks and similar public expenditures. The same study found that almost 75 percent of the total number of such municipal bonds had a bond size of less than $5,000,000, almost 84 percent a bond size of less than $10,000,000, and almost 92 percent a bond size of less than $25,000,000. Cynthia Belmonte, *Tax-Exempt Bonds*, 1996-2002 at 154, 168, *available at* www.irs.gov/pub/irs-soi/02govbnd.pdf. Although not all of such smaller bond issues were purchased in whole or in part by mutual funds,

those that were are far more likely to have been purchased by single state tax-exempt mutual funds than by national tax-exempt mutual funds.

II. IMPACT OF REQUIRING STATES TO GIVE IDENTICAL STATE TAX TREATMENT TO MUNICIPAL BONDS ISSUED IN OTHER STATES.

If the Court determines that states that currently exempt from their income tax interest on their own municipal issuers' bonds are constitutionally required to either grant such exemption to municipal bonds issued in other states or to tax all bond interest at the same rate, a substantial reconfiguration of the municipal bond market will follow. Such a holding would require a change in the tax policies and laws of the 42 states that currently exempt only some or all of their own municipal issuers' bonds from the applicable state's income tax, and would likely require a change in the tax policies and laws of a 43rd state (Utah) which exempts out-of-state bonds only for states that reciprocally exempt Utah's municipal bonds. Although it is difficult to forecast with precision the overall impact of such a seachange or its impact on individual states, it is clear that the disruption to the existing municipal bond market, and the adjustment from a system that has prevailed for close to a century, would be substantial.

As described above, the current marketplace is in part a national market and in part a state-by-state market. National funds purchase a majority by dollar amount of the municipal bonds purchased by mutual funds, but a substantial dollar amount is purchased by single state funds. Although statistics for purchases of municipal bonds by individuals (primarily higher income individuals, since the value of tax-exemption increases with the bondholder's tax bracket) and other categories of municipal bond purchasers are harder to pinpoint, it is likely that many such purchasers also allocate their municipal bond holdings, at least to some extent, between bonds of the

state in which they pay taxes (which provide a state tax benefit) and bonds issued in other states, which provide geographic and other types of credit diversification.

A determination that states are prohibited from limiting the state tax exemption to their own issuers' municipal bonds would eliminate relative tax treatment of in-state and out-of-state bonds as a consideration for municipal bond purchasers within a state. The relative value of a municipal bond would still vary state to state depending on the particular state's income tax rates and whether that state chose to subject all municipal bonds to such tax or to exempt all municipal bonds from such tax. Viewed in isolation, a determination by this Court that the dormant Commerce Clause requires each state to grant equally favorable state tax treatment to out-of-state bonds would increase relative demand in at least 42 states for municipal bonds issued in other states, with demand for out-of-state bonds increasing the most in the case of taxpayers in high tax states, where the tax advantage of buying in-state bonds is currently the highest. In theory, such demand shifts would reduce borrowing costs for issuers in states where the increase in demand from out-of-state bond purchasers was greater than the loss of demand from in-state bond purchasers, and increase borrowing costs for issuers in states where the loss of demand from in-state bond purchasers was greater than the increase in demand from out-of-state bond purchasers.

There would, however, be offsetting impacts on any demand realignment occasioned by an affirmance in this case. First, fiscal considerations could cause particular states to respond to constitutionally-mandated equal tax treatment of in-state and out-of-state municipal by taxing all municipal bonds. Such a response could reduce overall demand for municipal bonds—wherever issued—by tax-payers in such state. Second, an affirmance in this case would cause the virtual elimination of single state mutual funds as purchasers in the municipal

bond market. Because national tax-exempt bond funds have a shifting group of shareholders from all or most states, the state tax treatment of municipal bonds in any particular state has a substantially diluted effect on the demand by such funds for municipal bonds from any particular state. Thus, any realignment in demand and borrowing costs resulting from equal state tax treatment of out-of-state bonds in states that previously exempted only in-state bonds would be diluted by the increased role of national mutual funds as purchasers in the municipal bond market.

As noted above, one predictable impact of the elimination of tax incentives for the purchase of municipal bonds issued in a specific state would be the disappearance, through consolidation into national mutual funds, of single state mutual funds. Although a handful of single state funds might continue to exist for a small number of states (such as Florida) with high populations that have a high affinity for local bond issuers, the current state tax system is the *raison d'etre* for virtually all single state funds, and they would cease to be financially viable in the absence of a tax advantage that outweighed their relative lack of diversification vis-à-vis national funds and their reduced asset base.

The main adverse impact of the disappearance of single state funds as a substantial category of purchasers in the municipal bond market would be felt by small municipal issuers, which, as discussed above, constitute the majority by number, albeit a minority by dollar volume, of municipal entities that rely on the municipal bond market for financing of public needs. Large municipal bond issues would continue to find a home with national bond funds and other categories of municipal bond purchasers, at interest rates that, depending upon applicable demand reconfigurations, may be higher or lower than they would be under the current state tax system. The smaller, lesser-known and lower-rated issuers that constitute the numerical majority of the municipal bond market

would be adversely impacted by a number of factors. A principal category of buyers of their bonds, single state funds, no longer would be present in the market, and national mutual funds do not, and are unlikely to, focus their attention on such smaller bond issues.

Elimination of single state funds would lead to a reduction in the number of municipal mutual fund analysts employed within mutual fund complexes that offer a substantial number of such funds.[8] The reduction in personnel dedicated to evaluating municipal bonds issued in specific states for which single state mutual funds currently exist would translate into reduced purchases of the smaller and less familiar bond issues within each such state. In addition, national mutual funds place a higher premium on the liquidity of their holdings than do single state funds, which are willing to purchase less liquid municipal bonds of smaller and less familiar issuers because of the state tax advantage and the fund's mandate to purchase bonds issued within a specific state. The same liquidity concerns would likely impact demand for such bonds by individuals and other categories of municipal bond purchasers, who no longer would gain a state tax advantage as a countervailing benefit of owning such bonds. Such smaller issuers would stand to lose much of the intrastate market for the bonds that has developed under the currently prevailing state tax system without gaining much of an interstate market from its elimination.

As in other markets, the likely impact of a more national market for municipal bonds would be to tilt the market further towards larger, nationally-recognized market participants and to squeeze out or decrease the competitiveness of smaller and

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[8] One such NFMA member estimates that such a consolidation might result in a decrease of up to 50% in the number of municipal analysts it employs. Other NFMA members with fewer single state funds estimate a lesser impact.

more obscure participants. The difference, of course, between the municipal bond market and other markets is that the municipal bond market involves cities, towns, school districts, fire districts and other public entities, rather than independently-owned hardware stores, bookstores, pharmacies and the like. Local public issuers of municipal bonds that may face substantially higher borrowing costs or, in some cases, lose market access for their bond issues as a result of a state's inability to use its tax policy to promote the interests of its public sector will not be replaced by national chains. Accordingly, constitutionally-mandated equal state tax treatment for out-of-state public issuers could have adverse consequences for the lower rungs of the state public sector in a multitude of states that currently use tax policy to bolster the capital raising capabilities of their in-state public issuers.

The realignment of the municipal bond market occasioned by an affirmance in this case also would impact municipal bond investors. The value of outstanding municipal bonds issued in high tax states would decline by billions of dollars.[9]

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[9] For example, the outstanding principal amount of municipal bonds issued in California, New Jersey and New York, based on *The Bond Buyer* issuance statistics for the 1997-2006 period, is approximately $535 billion, $113 billion and $338 billion, respectively. The relative amounts of fixed rate municipal bonds and variable rate municipal bonds issued during the same period are approximately 81% and 19%, respectively. See Securities Industry and Financial Markets Association, *Municipal Bond Issuance – Coupon Type*, *available at* www.sitma.net/story.asp?id =2240. Discounting the approximate amount of outstanding bonds in the three sample states by a 19% factor to eliminate variable rate bonds (the interest rates on which would adjust upwards to compensate for any loss of value due to elimination of state tax exemption), the outstanding principal amount of long-term municipal bonds issued in those three states is approximately $433 billion, $91 billion and $274 billion, respectively. Assuming an affirmance in this case produces an increase in interest rates by 8, 20 and 12 basis points, respectively (see footnote 6, *supra*) in the applicable state-specific Lehman Brothers Municipal Bond Index rates in effect on July 16, 2007, and taking into account that bond prices move

All other things being equal, there would be commensurate increases in the aggregate value of bonds issued in lower tax states. It is an open question whether the adverse impact on investor psychology resulting from losses due to unanticipated legal changes in the structure of the municipal bond market would be offset by the unanticipated gains experienced by other investors in the same market as a result of the same unanticipated legal changes.

III. AFFIRMANCE WOULD PRODUCE WIDESPREAD AND POTENTIALLY PROLONGED LEGAL AND MARKET UNCERTAINTY.

As described in Section II above, a determination by the Court that the United States Constitution prohibits a state from exempting its public issuers' debt from state income taxation unless similar tax treatment is accorded to the debt of public issuers located in other states would result in a restructuring of the municipal bond market and affect borrowing costs and market access for a substantial segment of municipal issuers. These effects would be driven primarily by changes in the relative value to municipal bond purchasers of in-state versus out-of-state bonds.

In addition, the aftermath of such a Court decision would generate uncertainty by bond purchasers and bondholders over the tax treatment of municipal bonds in at least 42 states with tax statutes that treat some or all in-state municipal issuers more favorably than out-of-state municipal issuers.

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inversely to interest rates, the present value amount of the loss calculated by applying such rate differences to such outstanding principal amounts of long-term municipal bonds in those three states for the estimated remaining average life of such bonds of 7.12, 7.04 and 6.42 years, respectively, produces a dollar loss to investors in those three states of approximately $2.43 billion (California), $1.21 billion (New Jersey) and $2.18 billion (New York), or a loss of approximately $5.82 billion for owners of long-term bonds issued in those three states. Aggregate losses would be larger taking into account bonds issued in other high tax states.

Such uncertainty would linger during the period necessary for state legislatures and/or state and federal courts to decide whether to respond to such a prohibition by subjecting municipal bonds of their own public issuers to state income taxation or by expanding the exemption to municipal bonds issued in other states.

Such uncertainty would be compounded by uncertainty over whether states that resolved the required equalization of tax treatment of in-state and out-of-state municipal bonds by taxing in-state bonds would, in the case of outstanding bonds of in-state public issuers issued prior to the date of enactment of such change in tax treatment, (1) exempt such bonds for their remaining term, (2) subject such bonds to taxation prospectively or (3) subject such bonds to taxation for past periods as well as prospectively.[10] During the period of uncertainty as to state tax treatment, accurate valuation of municipal bonds would be impeded, diminishing the value of outstanding municipal bonds that are putatively exempt from state income tax and affecting the ability of municipal bond issuers in such states to capture the interest rate benefit of issuing putatively state tax-exempt bonds. The period of uncertainty could be prolonged by multi-year legal challenges to any determination by a state to tax outstanding bonds. In addition, if any state were to respond to the fiscal challenges presented by constitutionally-mandated equal state tax treatment of other states' bonds by taxing previously tax-exempt in-state bonds, the precedent set by such taxation of bonds originally sold on the premise of state tax-exemption could produce a substantial increase in bond purchasers' general perception of the degree of risk that favorable tax treatment of

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[10] This Court has held that, with respect to prior periods, an unconstitutionally discriminatory tax may be remedied either by providing a tax refund process for taxpayers that paid the tax or by prompt retroactive taxation of taxpayers that did not pay the tax. *Des Moines Nat'l Bank v. Bennett*, 284 U.S. 239, 247 (1931).

outstanding bonds may be eliminated during the term of the bonds, thereby inflicting a generalized increase in borrowing costs on long-term municipal bonds, which currently are purchased and priced on the premise that the tax-exemption features will remain applicable for the term of the bonds.

Each affected state would have to assess whether to exempt all income earned from municipal bonds, in-state and out-of-state alike, or to tax all bond income at the same rate. The relative simplicity of that choice, however, is belied by a multiplicity of complicating, state-specific factors, which include, *inter alia*: the level of tax revenue generated by the particular state's tax on income from out-of-state bonds; the borrowing cost savings attributable to state tax-exemption of its issuers' bonds; the level of potential income tax refund liability to holders of municipal bonds issued in other states; the specific terms of the state's constitution, of its general statutes conferring tax-exempt status on its public issuers' bonds and of the enabling acts establishing each particular bond issuer; the state's own constitutional provisions regarding retroactive taxation; and perceptions of the risk that impairment of contract claims will succeed if a state decides to tax outstanding bonds sold on the basis of state tax-exempt status. Given the variety of complicating factors, a Court determination that equal state tax treatment of other states' municipal bonds is mandated by the Constitution would produce disparate resolutions of the legal dilemma faced by the states, creating an aura of generalized unpredictability around a product—municipal bonds—that is currently perceived as a safe haven for risk-averse investors.

The NFMA endeavors in the following sections to provide a brief overview of some of the legal issues that would likely contribute to market uncertainty in the aftermath of an affirmance by this Court.

A. If a State Decides Not to Retroactively Tax Income Earned on Its Own Issuers' Municipal Bonds During Periods When Out-Of-State Municipal Bonds Were Taxed, It Will Face Higher Refund Liability.

If a state is precluded by its own constitution[11] from or otherwise chooses not to implement retroactive taxation of previously tax-exempt in-state bonds, it will face likely refund liability to taxpayers who paid state income tax in prior years on interest derived from out-of-state bonds. Such taxpayers would assert, based upon this Court's affirmance and the principle of retroactivity laid out in *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993),[12] that the state's taxation of such income was invalid, and their refund claims would be limited only by applicable limitations periods on

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[11] Numerous states have included in their constitutions an express prohibition on taxing interest earned on in-state bonds. *See, e.g.*, Ky. Const. § 171; Ohio Const. art. VIII, §§ 2k(D)(4), 2l(E), 2m(D), 2n(E), 2o(G), 2p(E) (interest on state bonds "shall at all times be free from taxation within the state"). In addition, various states have enacted statutes that create a covenant between the purchaser and the state in which the state agrees not to tax interest earned. *See, e.g.*, Cal. Gov't Code § 99016 (Deering 2007); Ga. Code Ann. § 32-10-49 (2007); Ky. Rev. Stat. Ann. § 58.580 (2006); N.Y. Pub. Auth. Law § 372 (McKinney 2004); Va. Code Ann. § 15.2-5361 (2007). These state-by-state variables would create further inconsistency across state lines.

[12] *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86 (1993) dictates that interpretations of federal law, including the Constitution, have full retroactive effect in cases involving taxation:

> When this Court applies a rule of federal law to the parties before it, that rule is the controlling interpretation of federal law and must be given full retroactive affect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our announcement of the rule . . . [W]e now prohibit the erection of selective temporal barriers to the application of federal law in noncriminal cases.

509 U.S. at 95.

refund claims based on the constitutional infirmity of a tax statute. The states are better sources than the NFMA for information as to the potential magnitude of such liability on a state-by-state basis, but the magnitude would likely be sufficient for at least some states to give substantial consideration to the option, if available, of retroactive taxation of in-state municipal bonds as an alternative to paying such refunds.

B. The Extent to Which States Can Retroactively Tax Income Earned on In-State Bonds in Past Years is Unclear, May Vary on a State-By-State and Issuer-By-Issuer Basis and is Likely to Lead to Litigation, Uncertainty and Devaluation of Municipal Bonds If Attempted.

Tax statutes may be retroactive, in the sense of applying to periods or transactions preceding enactment, if the operative legislation clearly so intends and due process considerations do not preclude such taxation.[13] In *Welch v. Henry*, 305 U.S. 134 (1938), this Court emphasized the case specific nature of analysis of whether retroactive taxation violates the Due Process Clause: "In each case it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation." *Id.* at 147 (upholding a retroactive tax that reached back three years). The Court has specifically rejected a taxpayer's reliance on existing tax legislation as in and of itself establishing a due process violation in the context of retroactive taxation; as the Court stated in *United States v. Carlton*, 512 U.S. 26,

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[13] "[T]he need of the government for revenue has hitherto been deemed a sufficient justification for making a tax measure retroactive whenever the imposition seems consonant with justice and the conditions were not such as would ordinarily involve hardship." *Untermyer v. Anderson*, 276 U.S. 440, 449 (1928) (Brandeis, J., dissenting); *see also Reinecke v. Smith*, 289 U.S. 172 (1933); *U.S. v. Hudson*, 299 U.S. 498, 500-01 (1937).

33-34 (1994), "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."

State courts have come down differently in various contexts involving retroactive taxation, and, in addition to this Court's interpretation of federal due process considerations as applied to retroactive taxation, each state's jurisprudence would need to be considered by the applicable state legislature and state courts as well as by holders of outstanding bonds issued in such state in determining the feasibility and validity of a state's responding to an affirmance in this case by legislating that taxpayers who held in-state municipal bonds that were issued, sold and valued as exempt from state income tax must pay taxes on income earned from those bonds in years past.[14] Moreover, because the jurisprudence surrounding retroactive taxation principally involves imposition of new taxes rather than revocation of express exemptions, the application of federal and state due process precedents to any such revocation would be a subject of additional uncertainty.

In short, if a state decided to retroactively tax income earned on in-state bond income, the case by case nature of balancing the fiscal needs of the state against the burden to taxpayers of being subjected to additional taxation in bygone tax years, and the varying periods for which different states might seek to impose retroactive taxation, would ensure prolonged legal uncertainty as to the validity of such taxation, and equally prolonged uncertainty as to whether such retro-

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[14] *See, e.g., Gardens at West Maui Vacation Club v. County of Maui*, 90 Hawai'i 334 (1999); *Gunther v. Dubno*, 195 Conn. 284 (1985); *Brennan v. Kirby*, 529 A.2d 633 (R.I. 1987); *Slewett & Farber v. Bd. of Assessors*, 438 N.Y.S.2d 544 (1981); *Keniston v. Bd. of Assessors of Boston*, 380 Mass. 888 (1980); *Pabst v. Comm'r of Taxes*, 136 Vt. 126 (1978); *Collins v. Comm'n*, 1968 WL 225 (Or. Tax 1968); *Colonial Pipeline Co. v. Commonwealth*, 206 Va. 517 (1966); *Allen v. Franchise Tax Bd.*, 39 Cal.2d 109 (1952).

active taxation was effective to nullify the validity of refund claims by holders of out-of-state bonds during the periods in question. Such uncertainty would adversely affect states as well as bondholders, and the mere attempt to impose retroactive taxation by one or more states would jolt a municipal bond market that depends on stability and reliable tax treatment for its relatively low interest rates.

C. The Extent to Which States Can Prospectively Tax Income Earned on In-State Bonds Issued on the Premise of State Tax-Exemption is Unclear, May Vary on a State-By-State and Issuer-By-Issuer Basis and is Also Likely to Lead to Litigation, Uncertainty and Devaluation of Municipal Bonds If Attempted.

A bond is a "contract" for purposes of an analysis under the Contract Clause. U.S. Const. art. I, § 10, cl. 1; *see W.B. Worthen Co. ex rel. Bd. of Comm'rs of Street Imp. Dist. No. 513 of Little Rock, Ark. v. Kavanaugh*, 295 U.S. 56 (1935).[15] It is less clear whether, for purposes of impairment of contract analysis under the Contract Clause of the Constitution, state tax exemption is a "term" of the bond that the state is prohibited from "impairing." The wording of general taxation statutes conferring a state tax-exemption on municipal bonds issued within the state, as well as of issuer-specific enabling acts that confer state tax-exemption specifically to that issuer's bonds, vary substantially, and the precise wording may affect a court's determination whether the statute creates a statutory covenant to maintain such tax-exempt treatment for the term of bonds issued pursuant to the

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[15] *See also* 64 Am. Jur. 2d Public Securities and Obligations § 27 ("The federal constitution and many state constitutions contain provisions prohibiting laws impairing the obligation of contracts, and public bonds, including the bonds issued by the various states of the Union and their political subdivisions, have been uniformly and consistently held to constitute contracts within the purview of such provisions").

applicable statute or is merely a statement of current tax treatment.

Precedent is sparse on whether extracontractual law that is not an express covenant with bondholders might be considered a "term" of a bond for purposes of an impairment of contract analysis.[16] In evaluating impairment of contract claims against state taxation of outstanding bonds previously treated as state tax-exempt, courts would need to decide whether the particular statutory provisions establishing state tax-exemption in effect at the time of issuance of a specific municipal bond are deemed to be part of the bond contract, and, if so, whether the state tax exemption is a "central" or "substantial" component of such contract.[17] Even a court

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[16] A court that has passed on the direct question is the Michigan Supreme Court in *City of Pontiac v. Simonton*, 271 Mich. 647 (1935), which opined that "laws in existence at the time of the issuance of municipal bonds, under the authority of which such bonds are issued, enter into and become a part of the contract to such an extent that the obligation of the contract cannot thereafter be impaired or fulfillment of the bond obligation hampered or obstructed by a change in such laws. But a contract obligation is not impaired by a change of law unless such change deprives a party of a substantial right or remedy." *Id.* at 651 (citing *Von Hoffman v. City of Quincy*, 71 U.S. 535 (1866). The *City of Pontiac* case has never been cited outside of the state of Michigan, except in one Arkansas case, *McArthur v. Smallwood*, 281 S.W.2d 428 (Ark. 1955), which was subsequently overruled. *See also* 64 Am. Jur. 2d Public Securities and Obligations § 27: "[T]he bar against impairment does not calcify the bond law beyond all possibility of amendment. The contract obligation is not impaired unless the alteration in the law deprives the bondholders of a substantial right or remedy."

[17] *Compare, e.g., Hutchinson, Shockey, Erley & Co. v. Evansville-Vanderburgh County Bldg. Auth.*, 644 N.E.2d 1228 (Ind. 1994) (holding that the legislature cannot change the maturity dates or interest rates on an outstanding bond) *with Morton Arboretum v. Thompson*, 605 F. Supp. 486 (D.C. Ill. 1984) (amendment of Toll Highway Act to create Highway Authority did not constitute an impairment of the bond contract; "[t]hough Bondholders' rights have been somewhat altered, they have not been 'substantially impaired.' Most importantly, Bondholders' right to payment—

determination that a change in tax treatment of an outstanding municipal bond is an impairment of the bond contract would not end the legal inquiry; an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose. *See United States Trust Co. of New York v. New Jersey*, 431 U.S. 1, 25-26 (1977).

The paucity of caselaw concerning these questions and the layers of issues involved in resolving an impairment of contract claim indicate that resolution of these matters will be far from predictable. State courts might ultimately reach disparate conclusions from state to state and/or bond issue by bond issue. The hazards of such prolonged uncertainty would fall both on holders of outstanding in-state bonds, who would be unable to predict the ultimate tax treatment or value of such bonds, and on the states, which faced with a potential but undetermined constitutional requirement to maintain the state tax-exemption on outstanding in-state bonds may be forced to choose between exempting all outstanding out-of-state bonds—and sustaining the associated loss of tax revenues—or taxing outstanding out-of-state bonds at the risk of an incremental refund obligation to their holders if the outstanding in-state bonds are ultimately determined to be constitutionally immune from state income taxation.

CONCLUSION

The NFMA presents the information herein in order to provide the Court with context concerning the scope, complexities and dynamics of the municipal bond market, as well as to outline the possible impact on such market of an affirmance. The NFMA hopes that this information helps inform the Court's decision-making process.

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the fundamental substantive right for which all the other procedural rights were conferred by the Resolution—has been assured." *Id.* at 492 (citing *City of El Paso v. Simmons*, 379 U.S. 497 (1965) and *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942)).

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No. 06-666

In the

Supreme Court of the United States

DEPARTMENT OF REVENUE OF KENTUCKY, ET AL.,

Petitioners,

v.

GEORGE W. DAVIS and CATHERINE V. DAVIS,

Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF FOR THE STATES OF NORTH CAROLINA, ALABAMA, ALASKA, ARIZONA, ARKANSAS, CALIFORNIA, COLORADO, CONNECTICUT, DELAWARE, FLORIDA, GEORGIA, HAWAII, IDAHO, ILLINOIS, INDIANA, IOWA, KANSAS, LOUISIANA, MAINE, MARYLAND, MASSACHUSETTS, MICHIGAN, MINNESOTA, MISSISSIPPI, MISSOURI, MONTANA, NEBRASKA, NEVADA, NEW HAMPSHIRE, NEW JERSEY, NEW MEXICO, NEW YORK, NORTH DAKOTA, OHIO, OKLAHOMA, OREGON, PENNSYLVANIA, RHODE ISLAND, SOUTH CAROLINA, SOUTH DAKOTA, TENNESSEE, TEXAS, UTAH, VERMONT, VIRGINIA, WASHINGTON, WEST VIRGINIA, WISCONSIN AND WYOMING AS AMICI CURIAE IN SUPPORT OF PETITIONERS

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INTERESTS OF AMICI CURIAE

For nearly a century, States have exempted interest on their own bonds from income taxation while taxing interest income on the bonds of sister States. The overwhelming majority of States have a taxation system comparable to Kentucky's. A decision by this Court proscribing this longstanding practice would injure the States in several distinct and important ways.

The States' sovereign interest in controlling their finances and debt service was recognized as far back as *The Federalist* No. 81, where Alexander Hamilton wrote that the Constitution did not "divest[]" the States "of the privilege of paying their own debts in their own way." *The Federalist* No. 81, at 488 (Alexander Hamilton) (Arlington House 1965). When the Commerce Clause is wrongly construed so as to unduly interfere with the ability of elected state officials to perform traditional state functions, the sovereignty of *all* States is adversely affected.

If the decision of the Kentucky Court of Appeals is affirmed, the 38 States that exempt their own bonds from state income taxation, while taxing the bonds of sister States, will face staggering potential liability. The amount at issue for even a single tax year will significantly impact state budgets. New York estimates that it will face claims of $200 million for past tax years and will lose annual revenue of approximately $70 million should the decision below be affirmed. The liability will be even greater in those States where challenges were filed several years ago. In North Carolina, for example, a class of taxpayers is seeking the refund of all income taxes paid on out-of-state bonds since 2001.

Finally, all States have a substantial interest in this appeal given its potential impact on the overall bond market. An affirmance of the Kentucky Court of Appeals would put the "bond market into an unprecedented upheaval." Timothy P.

Noonan & David Martin, *U.S. Supreme Court's Decision to Hear Municipal Bond Case Raises Constitutional, Procedural Questions*, 44 State Tax Notes 969 (2007). The bond market historically has reacted negatively to change, especially dramatic change. Any instability in the market stands to devalue substantially bonds held by the residents of all 50 States. Additionally, some States could see increases in their costs of borrowing. *See* Dwight Denison, Merl Hackbart & Michael Moody, *Davis v. Department of Revenue: A Preliminary Impact Assessment* 11 (Inst. for Federalism & Intergovernmental Relations Working Papers Series, Paper No. 2007-03, 2006), *available at* http://www.ifigr.org/publication/index.html (follow "No. 2007-03" hyperlink) (stating that elimination of state tax exemption "could have a dramatic impact upon municipal bond yields"). For this reason, all of the Amici States (regardless of their taxation system) have a strong interest in ensuring that the decision below is reversed.

SUMMARY OF ARGUMENT

The practice by States of exempting their own bonds from taxation, while taxing the interest on bonds of other States, is longstanding, widespread and well-known by Congress. This practice serves legitimate and important state interests. States exempt interest on their own bonds from income taxation because it allows them to lower their financing costs, improve their credit ratings and build more schools, hospitals, libraries and roads. Bond purchasers are willing to accept a lower interest rate for a tax-exempt bond than for a comparable taxable bond because they are motivated by the net return on investment (i.e., the income stream produced by the bond less taxes imposed on this income).

Tax exemption of municipal bonds is not without its costs. When a State exempts a bond from taxation, it forgoes a stream

of tax revenue that it would otherwise be entitled to receive over the life of the bond. States do not give up this income stream lightly. Rather, they generally forgo this income stream only when they know that what they are getting in return (more favorable interest rates) will benefit the State. Kentucky, like virtually every other State, exempts only its own bonds from taxation. This ensures that the tax revenue Kentucky is forgoing benefits the building of schools, hospitals, roads and other infrastructure in the State – the same use those taxes would have served had they been collected over the life of the bond. Kentucky's taxation system therefore serves legitimate state interests, unrelated to protectionism.

Kentucky's practice of exempting only Kentucky bonds from state income taxation helps state and local governments fulfill their essential functions; it does not favor private industry. Because this taxation system does not give in-state private industry a competitive advantage over out-of-state interests, it withstands scrutiny under *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1790 (2007).

Importantly, Kentucky is not similarly situated to other entities selling bonds in Kentucky. First, no other bond issuer is in the business of providing public works within the State of Kentucky. Second, only Kentucky can forgo collecting income tax upon its bonds and, by doing so, ensure that the tax revenue that Kentucky is forgoing will still serve to facilitate the building of schools, hospitals and roads in Kentucky. Kentucky is therefore unique among other entities selling bonds within Kentucky. The Kentucky Court of Appeals therefore erred in concluding that the Kentucky taxation system violates the dormant Commerce Clause.

The lower court also erred in concluding that Kentucky is not a market participant. When States act as market participants, their actions are free from dormant Commerce Clause analysis. Here, Kentucky is merely agreeing to forgo

collecting a tax in order to obtain more favorable terms for a product that Kentucky itself is selling in the marketplace. Kentucky therefore is a market participant.

If the decision of the Kentucky Court of Appeals is upheld, the impact on States and bondholders will be devastating. Given Congress' implicit approval of this longstanding, widespread and well-known taxation practice, any change should be made by Congress, not the courts.

ARGUMENT

This Court has "long recognized that principles of federalism and comity generally counsel that courts should adopt a hands-off approach with respect to state tax administration." *Nat'l Private Truck Council v. Okla. Tax Comm'n*, 515 U.S. 582, 586 (1995); *see also Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940) (recognizing that States should be free to pursue their own fiscal and taxing policies). Those principles apply with particular force in this case. For nearly a century, States have exempted from taxation the interest earned on their own bonds, while taxing interest income from the bonds of other States. This practice has been acknowledged and countenanced by Congress and this Court. To suddenly strike it down in the name of the dormant Commerce Clause would be a stark departure from tradition, one with potentially devastating consequences for the States. This Court's Commerce Clause jurisprudence requires no such result.

To the contrary, state laws that favor local government serve legitimate, non-protectionist interests and are therefore consistent with the Commerce Clause, under both the anti-discrimination and market participant lines of cases. This Court has also recognized that congressional acquiescence in longstanding state practices militates in favor of sustaining such practices. Kentucky's tax system should be upheld.

I. A STATE LAW PROVIDING INCOME TAX EXEMPTIONS FOR INTEREST EARNED ON BONDS ISSUED BY THE STATE AND ITS POLITICAL SUBDIVISIONS, BUT NOT INTEREST EARNED ON BONDS ISSUED BY OTHER STATES AND THEIR POLITICAL SUBDIVISIONS, DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE.

In *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786, 1795-96 (2007), this Court rejected the charge that a "law[] favoring local government" was facially discriminatory within the meaning of the dormant Commerce Clause and therefore invalid. The Court recognized that the "government is vested with the responsibility of protecting the health, safety, and welfare of its citizens," and that "[t]hese important responsibilities set state and local government apart from typical private business." *Id.* at 1795. The Commerce Clause was not intended to, and has never been understood to, stand in the way of the States directly engaging in those activities – be they processing garbage, running prisons, financing capital improvements or constructing roads.

Laws favoring local government are consistent with the Commerce Clause because local government is not "similarly situated" to potential competitors and because "[l]aws favoring local government . . . may be directed toward any number of legitimate goals unrelated to protectionism." *Id.* at 1796. Courts "should be particularly hesitant to interfere with [a government's] efforts under the guise of the Commerce Clause" where the government is engaged in what "is both typically and traditionally a local government function." *Id.* (citation and quotation marks omitted).

All of these considerations apply with full force in this case and support upholding Kentucky's tax system. When States sell bonds to pay for hospitals, roads, prisons and other

important capital projects – and exempt the interest on those bonds from state income taxes to lower the bonds' effective cost to the State – they are engaging in a traditional government activity that serves core sovereign functions. Out-of-state governmental bond issuers are not similarly situated to the taxing State and its political subdivisions, and legitimate interests are served by the States' common practice of exempting the interest earned on their own bonds from taxation, but not extending that exemption to bonds issued by other States.

A. This Practice Is Longstanding and Widespread.

The practice by States of exempting their own bonds from taxation, while taxing the bonds of sister States, dates back to the beginning of state income tax statutes. *See, e.g.*, 1919 N.Y. Laws 1641-42; 1921 N.C. Sess. Laws 208; 1921 Mass. Acts 616; 1923 N.H. Laws 78; 1926 Va. Acts 961; 1927 S.C. Acts 7; 1929 Ark. Acts 585; 36 Del. Laws 37 (1929); 1936 Ky. Acts 70; *see also* 1901 Hawaii Sess. Laws 31-32 (territorial practice that continued following statehood).

This longstanding practice is grounded in this Court's decision in *Bonaparte v. Tax Court*, 104 U.S. 592 (1881). In *Bonaparte*, this Court held that New York, by exempting its own bonds from taxation, could not compel Maryland to refrain from taxing those bonds when acquired by a Maryland resident. In rendering its decision, this Court declared:

> [I]f a State could protect its securities from taxation everywhere, it might succeed in borrowing money at reduced interest; but, inasmuch as it cannot secure such exemption outside its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as

> individuals. . . . [T]he States are left free to extend the comity which is sought, or not, as they please.

Id. at 595. With this Court's imprimatur, and the longstanding acquiescence of Congress, state legislatures have enacted and enforced taxation systems for a hundred years with the belief that whether a State exempts the bonds of a sister State is an issue of comity that may be "extend[ed], or not, as [States] please." *Id.*

This historical practice by States of only exempting their own bonds from taxation continues today. Virtually all States that have a state income tax exempt their own bonds, but tax the bonds of sister States.[1] As reflected by this nearly universal

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[1] Ala. Code § 40-18-14(3)(f) (2003); Ariz. Rev. Stat. Ann. § 43-1021(3) (Supp. 2006); Ark. Code Ann. § 26.51-404(b)(5) (1997); Cal. Rev. & Tax. Code § 17133 (West 2004); Colo. Rev. Stat. § 39-22-104(3)(b) (2006); Conn. Gen. Stat. Ann. § 12-701(a)(20)(A)(i), (B)(vii) (West Supp. 2007); Del. Code Ann. tit. 30, § 1106(a)(1) (1997); Ga. Code Ann. § 48-7-27(b)(1)(A) (2005); Haw. Rev. Stat. §§ 39-11, 47-13, 235-7(a)(5), (a)(6), (b)(2) (1993); Idaho Code Ann. § 63-3022M(1), -3022M(3)(b) (2007); Kan. Stat. Ann. § 79-32,117(b)(i) (Supp. 2006); Ky. Rev. Stat. Ann. § 141.010(10)(c) (West Supp. 2006); La. Rev. Stat. Ann. §§ 47:48 (2001), 47:293(6)(a), (b) (Supp. 2007); Me. Rev. Stat. Ann. tit. 36, § 5122(1)(A) (Supp. 2006); Md. Code Ann., Tax-Gen. §§ 10-204(b), 10-305(d) (LexisNexis Supp. 2006); Mass. Gen. Laws Ann. ch. 62, § 2(a)(1)(A) (West Supp. 2007); Mich. Comp. Laws Ann. § 206.30(1)(a) (West Supp. 2007); Minn. Stat. Ann. § 290.01(19a)(1)(i) (West 1999); Miss. Code Ann. § 27-7-15(4)(d) (Supp. 2006); Mo. Ann. Stat. § 143.121(2)(b) (West Supp. 2007); Mont. Code Ann. § 15-30-111(1)(a)(i), (2)(a)(i) (2005); Neb. Rev. Stat. § 77-2716(1)(a), (c) (Supp. 2006); N.H. Rev. Stat. Ann. § 77:4(I) (Supp. 2006); N.J. Stat. Ann. § 54A:6-14 (West 2002);

practice and by the submission of this amici brief on behalf of 49 States in support of Kentucky, "the entities which supposedly suffer by discriminatory taxation of municipal bond income – the states themselves – have never challenged the practice[, and] have almost uniformly adopted this method of subsidizing local public works bonds." Scott K. Attaway, Note, *The Case for Constitutional Discrimination in Taxation of Out-of-State Municipal Bonds,* 76 B.U. L. Rev. 737, 767 (1996).

B. The Widespread Practice by States of Exempting Their Own Bonds, While Taxing the Bonds of Sister States, Is Directed Toward Legitimate Goals Unrelated to Protectionism.

1. To understand why States do not extend the tax exemption to bonds issued by other States, it is helpful to understand why States grant the exemption to their own bonds.

N.M. Stat. § 7-2-2(B)(3), (V) (2005); N.Y. Tax Law § 612(b)(1) (McKinney Supp. 2006); N.C. Gen. Stat. § 105-134.6(c)(1) (2007); N.D. Cent. Code § 57-38-01.2(1)(g) (2005); Ohio Rev. Code Ann. § 5747.01(A)(1) (LexisNexis Supp. 2007); Okla. Stat. Ann. tit. 68, §§ 2358 (A)(1), 2358.5A(A) (West Supp. 2007); Or. Rev. Stat. § 316.680(2)(a) (2005); 72 Pa. Stat. Ann. §§ 7302, 7303(a)(6), 9901 (West Supp. 2007); R.I. Gen. Laws § 44-30-12(a), (b)(1) (Supp. 2006); S.C. Code Ann. § 12-6-1120(1) (2000 & Supp. 2006); Tenn. Code Ann. § 67-2-104(e)(1) (Supp. 2006); Vt. Stat. Ann. tit. 32, § 5811(18)(A)(i)(II) (Supp. 2006); Va. Code Ann. § 58.1-322(B)(1) (Supp. 2007); W. Va. Code Ann. § 11-21-12(b)(1)(LexisNexis Supp. 2007); *but see* Ind. Code Ann. § 6-3-1-3.5 (LexisNexis Supp. 2006) (extending the exemption to interest earned on bonds issued by governmental entities outside Indiana).

As an initial matter, bond issuances are essential for States to provide needed services to their residents. Not only do they allow States to undertake necessary capital improvements without having to impose exorbitant taxes, they also allow States to spread the cost of the project over its life. Robert S. Amdursky & Clayton P. Gillette, *Municipal Debt Finance Law: Theory and Practice* § 1.1.3, at 10-11 (1992). Thus, bond issuances ensure that the cost of the State's capital improvements will be distributed fairly among taxpayers over the life of those improvements.

The tax exemption of bonds allows state and local governments to pay lower interest rates compared with rates paid on taxable corporate bonds of equal risk and maturity. *See* Michael J. Graetz & Deborah H. Schenk, *Federal Income Taxation: Principles and Policies* 215-16 (5th ed. 2005). A rational bond purchaser takes into account the total cost of the bond (*i.e.*, the original purchase price less the taxes that will have to be paid on it). *Laura v. Droll,* 187 N.W. 876, 878 (Neb. 1922) ("It is self-evident that an investor is concerned mainly with the net returns upon his investment, and if the state or its municipalities issues a security drawing a certain rate of interest, and at the same time taxes the owner of the security a given rate, his net return is the difference between the amount of taxes paid thereon and the amount of interest received.").

If a bond is exempt from taxation, the potential purchaser will be willing to pay more for the bond (or accept a lower interest rate). Thus, when a State, such as Kentucky, sells a bond in the marketplace, it can either: (1) tax the income from that bond over time or (2) exempt the bond from taxation and thereby obtain a more favorable interest rate. Instead of collecting taxes on its bonds over the terms of the bonds and then remitting these tax payments to the specific projects being financed, Kentucky has effectively reinvested these taxes back

into the projects at the outset by obtaining more favorable interest rates when the bonds are issued.[2]

The tax exemption not only allows States to obtain more favorable financing terms, it also gives States the option of borrowing greater sums without jeopardizing their credit ratings. A State's credit rating directly affects the State's borrowing costs. If a State is unable to maintain an acceptable credit rating, its borrowing costs will become prohibitively high. *See* Robert Lamb & Stephen P. Rappaport, *Municipal Bonds: The Comprehensive Review of Tax Exempt Securities and Public Finance* 52 (1980). By exempting its own bonds from taxation, a State can lower its borrowing cost and, consequently, borrow a greater amount without jeopardizing its credit rating.

All told, the tax exemption of bonds is an indispensable tool in ensuring the States' fiscal needs. States have chosen to exempt their own bonds from taxation because it allows them to lower their borrowing costs and to increase the amount of money available to build schools, hospitals and roads.

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[2] Thus, with each debt-service payment, Kentucky is collecting an implicit tax on Kentucky bonds in lieu of the explicit tax that Kentucky collects on the bonds of other States. *See* Edward Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Values*, 19 Cardozo L. Rev. 861, 912 (1997) (stating that "the owners of municipal bonds . . . pay an implicit tax in the form of higher purchase prices and lower rates of return"); Edward Yorio, *Equity, Efficiency and the Tax Reform Act of 1986*, 55 Fordham L. Rev. 395, 398 (1987) ("It is generally acknowledged that the rate of return on [tax-exempt] bonds is lower than the rate of return on comparable, fully-taxable investments of equivalent risk. To the extent of the difference between those rates of return, the investor is in effect paying an 'implicit tax.'").

2. Kentucky, like almost every other State in the Union, has concluded that the tax exemption for interest income should not be extended to its sister States' bonds. There are sound and sensible reasons for this decision. When Kentucky exempts its bonds from taxation, it is sacrificing future tax revenues from those bonds so that more money can be invested in Kentucky schools now. If Kentucky were to exempt the bonds of other States from taxation, it would be giving up state income taxes without any corresponding benefit to the construction of public works in Kentucky. Thus, granting a tax exemption to bonds issued by Kentucky and its subdivisions furthers the State's legitimate interests. Granting a tax exemption for out-of-state bonds does not. Kentucky should not be forced to forgo state tax revenues to fund the construction of schools in other States. *See Reeves, Inc. v. Stake*, 447 U.S. 429, 442 (1980) (concluding that dormant Commerce Clause does not preclude a State from "restricting to state residents the enjoyment of state educational institutions, energy generated by a state-run plant, police and fire protection, and agricultural improvement and business development programs"). Although Kentucky has a core sovereign interest in the exercise of its borrowing, spending and taxing powers, Kentucky has no stake in the price of other States' bonds and in the trade-off that other States make between collecting funds sooner rather than later.

This Court has stressed that the Commerce Clause does not "prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 336 (1977). In fact, it is "a laudatory goal in the design of a tax system to promote investment that will provide jobs and prosperity to the citizens of the taxing State." *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 385 (1991). Kentucky – and the other 37 States with similar tax systems – are merely seeking to effectuate those objectives.

C. The States' Treatment of Interest Earned on State and Local Bonds Is Not Discriminatory Within the Meaning of the Dormant Commerce Clause.

In *United Haulers*, the Court recognized that "it does not make sense to regard laws favoring local government and laws favoring local private industry with equal skepticism." 127 S. Ct. at 1795. This is because "laws favoring local government" typically further legitimate, non-protectionist interests and because local government is not "similarly situated" to potential competitors. *Id.* States furnish public services to their citizens; no other entity competes with a State to undertake that traditional obligation. All this holds true with respect to States' treatment of interest earned on government bonds.

Kentucky's taxation system helps state and local governments fulfill their essential functions; it does not favor private industry. The system does not give any private industry based in Kentucky a competitive advantage over private industries located out-of-state. The statutes at issue achieve a single and simple purpose – the *State* is allowed to give up future tax revenue to obtain better financing terms on the bonds it issues. These bonds then help finance capital improvements necessary to the well-being of the State's residents. Because Kentucky's taxation system "treat[s] in-state private business interests exactly the same as out-of-state ones," it does not violate the dormant Commerce Clause. *Id.* at 1797.

Moreover, the dormant Commerce Clause is focused on the differential treatment of entities that are substantially similar. "'[A]ny notion of discrimination assumes comparison of substantially similar entities.'" *Id.* at 1795 (quoting *Gen. Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997)). Because Kentucky is not substantially similar to other bond issuers, Kentucky's practice is not discriminatory.

No other State is in the business of providing public works within the State of Kentucky. Additionally, Kentucky is the only State that can agree to forgo the payment of taxes that would otherwise be due to the Kentucky Treasury and thereby obtain better financing terms for infrastructure to be built in Kentucky. Kentucky stands in the unique position of being both the seller and the tax collector with respect to its bonds. No other State stands in this same position with respect to Kentucky state taxes. Consequently, Kentucky is not similarly situated for Commerce Clause purposes with other issuers selling their bonds in Kentucky.

This is precisely the lesson of *Bonaparte*. The Court recognized that because a State bond issuer "cannot secure such an exemption outside of its own jurisdiction, it is compelled to go into the market as a borrower, subject to the same disabilities in this particular as individuals." 104 U.S. at 595. When another State seeks to sell bonds to Kentucky residents, it does not do so as a sovereign governing those residents. It does so as an economic actor trying to convince Kentucky residents that investing in its bonds would be wiser than investing in, say, IBM stock. The relationship between Kentucky and its residents – in general and specifically with respect to the sale and tax treatment of its bonds – is far different. Kentucky stands in the unique position of being the seller, tax collector and spender with respect to its bonds.

General Motors cements the point. In that case, the Court was faced with a challenge to Ohio's taxation system on natural gas sold within the State. Although Ohio imposed a sales and use tax on natural gas, Ohio excepted regulated public utilities from this tax. The Court held that Ohio's taxation system did not violate the dormant Commerce Clause because regulated public utilities were not similarly situated to other sellers of natural gas. Because regulated public utilities were required to provide gas bundled with other services – such as serving all members of the public without

discrimination, "providing a firm backup supply of gas," and assuring continued service to low-paying customers – the products that they sold differed from the products sold by independent gas marketers. *Gen. Motors Corp.*, 519 U.S. at 297, 303-04. The Court emphasized that these services provided by the utilities "serve[] important interests in health and safety" and that "health and safety considerations [may] be weighed in the process of deciding the threshold question whether the conditions entailing application of the dormant Commerce Clause are present." *Id.* at 306, 307.

So too, here, the entity that is receiving favorable tax treatment is an entity whose mission is furthering the public interest of people in the taxing State. Indeed, it is the one entity that, under our constitutional structure, is charged solely with serving the interests of the citizens of Kentucky. The favorable tax treatment of Kentucky bonds helps in achieving those public interests – just as in *General Motors*. This would not be the case with respect to other private and public bond issuers. For purposes of the Commerce Clause, Kentucky is not similarly situated to other issuers of bonds.

The manner in which Kentucky has chosen to finance state and local government is consistent with an "essential and patently unobjectionable purpose of state government – to serve the citizens of the State." *Reeves*, 447 U.S. at 442. The State does not discriminate against interstate commerce when it chooses not to finance other state governments at the same time.

II. AS A SELLER OF BONDS, KENTUCKY STANDS AS A MARKET PARTICIPANT.

The dormant Commerce Clause does not "limit the ability of the States themselves to operate freely in the free market." *Reeves*, 447 U.S. at 437. Rather, when States act as "market participants," as consumers or vendors, their actions are

exempt from Commerce Clause analysis. *Id.* at 439. It is only when the States act as regulators that Commerce Clause analysis is triggered.

The critical issue in distinguishing between the State as a regulator and as a market participant is whether the provision in question affects private trade and not the State's own trade. As this Court concluded in *White v. Mass. Council of Constr. Employees*, 460 U.S. 204, 218 (1983), whether a State is viewed as a market participant "should turn primarily on whether a particular state action more closely resembles an attempt to impede trade among private parties, or an attempt, analogous to the accustomed right of merchants in the private sector, to govern the State's own economic conduct and to determine the parties with whom it will deal."

A State's issuance of bonds and the tax treatment it accords those bonds is a classic example of a State acting in its role of market participant. When a State sells a bond, it is entering into a contractual agreement to repay a loan over time. The State's covenant with the bond purchaser that it will not tax the bond, in turn, is an essential aspect of that contractual agreement because it directly establishes the net return the bondholder will obtain on his investment. Accordingly, Kentucky's agreement to forgo the collection of state income tax cannot be separated from its status as a seller seeking to obtain the best possible terms for its product in the marketplace. The Kentucky Court of Appeals' decision attempting to separate Kentucky's role as a bond seller from its role in setting the tax status for those bonds should be rejected.

Respondents mistakenly contend that this Court's decision in *New Energy Co. v. Limbach*, 486 U.S. 269 (1988), dictates that Kentucky should not be treated as a market participant. *See* Br. in Opp. 11-13. *New Energy*, however, is not on point. In *New Energy*, Ohio provided favorable tax treatment for purchases of ethanol only if the ethanol was produced in Ohio or in a State that granted similar tax advantages to ethanol

produced in Ohio. As such, Ohio was not acting as a seller or purchaser itself but was instead attempting to provide economic benefit to particular private entities. Here, unlike in *New Energy*, Kentucky's tax treatment of its bonds is an integral part of its sale of its own product. The market participant doctrine thus clearly applies.

III. THE RULE ADOPTED BY THE LOWER COURT WOULD HAVE DEVASTATING EFFECTS ON THE STATES' FISC AND THE BOND MARKET, AND REFLECTS A DECISION BETTER LEFT TO CONGRESS.

If the decision of the Kentucky Court of Appeals is upheld, the impact upon the States' fisc will be devastating. Moreover, such a holding will likely destabilize the bond market. Any change to this longstanding taxation practice is better left to Congress, which has thus far countenanced the practice.

1. If a State's tax system is found to be discriminatory in violation of the dormant Commerce Clause, the State has three options to remedy the violation: (1) refund the additional taxes paid by the taxpayers who suffered an undue burden, (2) retroactively impose higher taxes on those who benefitted by the discrimination or (3) some combination of both. *Fulton Corp. v. Faulkner*, 516 U.S. 325, 346-47 (1996). Although a State could, in theory, correct past discrimination by retroactively imposing a higher tax on the holders of tax-exempt bonds who benefitted by the discrimination, that option is not realistic for most States. First, States would face significant constitutional and political hurdles if they were to attempt to increase retroactively taxes for tax years that are already

closed.[3] Second, numerous States have state constitutional provisions that preclude their legislature from taxing their own State's bonds.[4] Third, many States have statutory provisions that create a covenant between the bondholder and the State in which the State agrees, for the life of the bond, not to tax interest arising from the bond.[5]

Should the decision below be affirmed, most States would therefore be faced with refunding any taxes deemed to be discriminatory. For some States, that liability will go back for seven or more years.[6] New York, which generally allows tax refund claims to be submitted for three years following the filing of the return, estimates that the refund claims it faces total $200 million. Thus, States are looking at collective liability in the billions of dollars should this longstanding state practice be declared unconstitutional.

In addition to being subject to claims totaling billions, States will lose a substantial revenue stream on a going forward basis. State and municipal bonds are frequently issued for

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[3] North Carolina, for example, cannot realistically impose a retroactive tax on all taxpayers who held tax-exempt North Carolina bonds during calendar year 2001 (the first tax year at issue in a pending class action filed against the State).

[4] *See, e.g.*, Ky. Const. § 171; Ohio Const. art. VIII, §§ 2k(D)(4), 2l(E), 2m(D), 2n(E), 2o(G), 2p(E) (interest on state bonds "shall at all times be free from taxation within the state").

[5] *See, e.g.*, Cal. Gov't Code § 99016 (Deering 2007); Ga. Code Ann. § 32-10-49 (2007); Ky. Rev. Stat. Ann. § 58.580 (West Supp. 2006); N.Y. Pub. Auth. Law § 372 (McKinney 2004); Va. Code Ann. § 15.2-5361 (2007).

[6] *See, e.g., Dunn v. State*, 635 S.E.2d 604 (N.C. Ct. App. 2006) (class action seeking refund for tax years 2001 and forward), *disc. review granted*, 361 N.C. 351 (2007).

terms of up to 40 years, depending upon the nature of the project being financed. If a State is contractually obligated to treat previously-issued bonds as tax-exempt, that State may be locked into exempting all bonds (both bonds previously issued by the State and the bonds of its sister States) for the next 40 years. Thus, the existence of outstanding bond issuances may well limit the ability of States to tax prospectively all bonds the same. The only choice for many States may be to exempt all bonds for decades to come. States and local governments will then be forced to raise other taxes substantially to replace this lost revenue.

North Carolina's experience following *Fulton* illustrates the budgetary crises that States will face should the decision below be affirmed. In *Fulton*, this Court concluded that North Carolina's intangibles tax violated the dormant Commerce Clause. 516 U.S. at 346-47. The *Fulton* decision involved a single taxpayer who had challenged the tax. Shortly after the *Fulton* decision, however, a class action was filed by a different litigant on behalf of all taxpayers who had paid the intangibles tax to the State. *See Smith v. State*, 507 S.E.2d 28 (N.C. 1998). In that action, the North Carolina Supreme Court held that all intangible taxes collected by the State of North Carolina from 1991 through 1994 had to be repaid by the State. North Carolina ultimately paid $586 million in settlement of the class action. The combined effect of repaying this sum and losing a significant revenue stream contributed to a state budgetary crisis that required the Governor to declare a state of fiscal emergency. Christopher Kirkpatrick, *Easley Declares Fiscal Emergency*, Durham Herald Sun, Feb. 9, 2001, at A1. Over a decade after the *Fulton* decision, the State of North

Carolina remains in litigation over the emergency measures that were taken to keep the doors of State government open.[7]

2. If the decision of the Kentucky Court of Appeals is upheld, the bond market will also be substantially impacted. *See* Noonan, *supra*, at 969 (noting upheaval that will occur in bond market). Bondholders face a risk of substantial devaluation of their bonds, particularly bonds issued by States with high state income taxes.[8] Individuals who hold such bonds may see the market value of their assets decline. *See* Denison, *supra*, at 10. Moreover, such losses will cause many investors to be less inclined to make future purchases of municipal bonds.

3. Respondents are asking this Court to dramatically alter how the States have taxed bonds for the past hundred years. Such a change is best left in Congress' hands. "The Constitution gives that branch of government [Congress] the power to regulate commerce among the states, and until it acts . . . we should enter the field with extreme caution." *Gen. Motors*, 519 U.S. at 310 (quoting *Northwest Airlines, Inc. v.*

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[7] *See Goldston v. North Carolina*, 637 S.E.2d 876 (N.C. 2006) (challenge to Governor's emergency appropriation from State Highway Trust Fund); *see also Coley v. State*, 631 S.E.2d 121 (N.C. 2006) (challenging mid-year increase of state income taxes); *County of Cabarrus v. Tolson*, 610 S.E.2d 443 (N.C. Ct. App. 2005) (challenging Governor's emergency appropriation of funds originally earmarked for local government).

[8] Although many States will not have the option of retroactively taxing bonds that were originally issued as "tax-exempt" by the State, the remedy that is ultimately implemented in each State must be determined, as an initial matter, by state legislatures and state courts. Until the specific remedy becomes settled for each State, the uncertainty as to whether States may tax all bonds will significantly depress the value of "tax-exempt" bonds.

Minnesota, 322 U.S. 292, 302 (1944) (Black, J., concurring)); *see also Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992) (concluding that burden on interstate commerce is "not only [a determination] that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve").

This is especially true where Congress has long been aware of a common state taxing practice and has taken no action to forbid it. As this Court observed more than 125 years ago, "[t]he long continued silence of Congress, with its plenary power, in the presence of . . . [state legislation] is itself an implied ratification and adoption, and is equivalent in its consequences to an express declaration to that effect." *Wilson v. McNamee*, 102 U.S. 572, 575 (1880); *see also Gen. Motors Corp.*, 519 U.S. at 305 (concluding that Congress' failure to alter a longstanding state practice indicates that Congress believes the practice to be "within the realm of what the States may reasonably promote and preserve"). That is exactly the situation here. Although Congress has carefully studied the States' longstanding practice with respect to the exemption of interest earned on government bonds, it has chosen not to alter or ban it.

For example, in 1959, Congress directed both the Committee on the Judiciary of the House of Representatives and the Committee on Finance of the Senate to make a full and complete study of "all matters pertaining to the taxation by the States of income . . . from the conduct of business activities which are . . . a part of interstate commerce." Pub. L. 86-272, § 201, 73 Stat. 555, 556 (1959). The resulting reports of the Special Subcommittee on State Taxation of Interstate Commerce were presented to Congress in 1964 and 1965. The Subcommittee sought to identify "the conflicts between the tax policies of the States and the national policy of assuring the free flow of commerce." Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary,

House of Representatives, State Taxation of Interstate Commerce, H.R. Rep. No. 88-1480, at iii (1964).

In its report, the Subcommittee detailed the practice by States of exempting their own bonds from taxation, while taxing the bonds of other States. H.R. Rep. No. 88-1480, pt. 2, at 258-59 (1964). The report expressly listed the States that engaged in this practice and those that did not. *Id.* at 259, H.R. Rep. No. 88-1480 app. L at A371-A433 (1964). The report, however, did not identify the taxation of bonds as an area of conflict between State and national policy. The study therefore made no recommendation of change in this area. Rather, the study made the general recommendation that States "should be as free as possible to pursue their own tax policies even though they are at variance with the Federal policy." H.R. Rep. No. 89-952, pt. 6, at 1159 (1965). Congress made no effort to change taxation of state and local bonds after receiving the Subcommittee's report.

On numerous other occasions, Congress has been made aware that most States exempt their own bonds from state taxation while taxing the bonds of other States. *See, e.g.*, H.R. Rep. No. 91-413 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1825 ("State and local governments generally do not directly tax interest on Federal bonds, but they tax the interest income on bonds issued by other States."); S. Rep. No. 91-552 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2253 (noting state practice of taxing bonds of other States). Thus, Congress is well aware of, and has carefully studied, this practice. Its failure to act strongly supports the practice's validity under the Commerce Clause.[9]

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[9] Another indication of Congress' at least implicit approval of the practice is its actions with respect to Hawaii. In 1901, the United States territory of Hawaii began exempting its own bonds from taxation while taxing the bonds of the States and other territories.

* * * * *

The decision of the Kentucky Court of Appeals interferes with a fundamental aspect of state sovereignty – the ability of States to determine the most appropriate means of raising revenue in order to provide for the common good. Principles of state sovereignty counsel that this Court should exercise restraint in restricting the manner in which Kentucky undertakes to sell its bonds. *See Reeves, Inc. v. Stake*, 447 U.S. 429, 438 (1980). Federal solicitude for the States' power to manage their debts goes back to the founding of the Republic. *See, e.g., The Federalist* No. 81 (Alexander Hamilton) (Arlington House 1965); *accord Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 328 (1977) ("The Commerce Clause does not . . . eclipse the reserved 'power of the States to tax for the support of their own governments.'") (quoting *Gibbons v. Ogden*, 22 U.S. 1, 199 (1824)). Kentucky's legislature should be permitted to determine whether it makes good economic sense for the State to forgo payment of taxes on Kentucky bonds in order to obtain more money now (and better

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1901 Hawaii Sess. Laws 31-32. Although Congress had clear authority to override this practice, it did not do so. *See* U.S. Const. art. IV, § 3, cl. 2; *Nat'l Bank v. County of Yankton*, 101 U.S. 129, 133 (1880). In fact, during the 59 years that Hawaii was a territory of the United States, the tax exempt bonds that Hawaii issued were expressly approved by Congress and the President of the United States. *See, e.g.*, 31 Stat. 161 (1900) (Hawaii Organic Act) (bond issuances to be approved by the President); 66 Stat. 133 (1952) (Congressional approval of Hawaii bond issuance). Moreover, when Hawaii was ultimately admitted into the Union, Congress recognized that Hawaii's territorial laws (which at the time included tax exemption for Hawaii bonds but not other States) "shall continue in force." 73 Stat. 4, 11 (1959).

financing terms) to build schools, hospitals and roads. The dormant Commerce Clause does not require that this choice be taken out of the hands of Kentucky's elected officials.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

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IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,
Respondents.

ON WRIT OF CERTIORARI TO THE COURT OF APPEALS OF KENTUCKY

BRIEF *AMICUS CURIAE* OF NUVEEN INVESTMENTS, INC., IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE*[1]

Founded by John Nuveen in 1898 as an underwriter and trader of bonds, Nuveen Investments, Inc. has been an innovative participant in the municipal bond market for more than a century. The principal business of Nuveen Investments is asset management and related research, as well as the development, marketing, and distribution of investment products and services for the institutional and individual high-net-worth market segments.

As of June 29, 2007, Nuveen had approximately $63.6 billion in municipal assets under management. A significant portion of those assets are held in closed-end and open-end funds, which Nuveen Investments began offering in 1976. Currently, Nuveen offers state-specific closed-end and open-end bond funds, that is, funds that include tax-exempt bonds issued by a particular state and its political subdivisions, for 23 states, including Kentucky. As of June 29, 2007, Nuveen's Kentucky Municipal Bond Fund held assets valued at approximately $450 million.

As an organization with long experience and ongoing participation in the municipal bond market, Nuveen Investments is keenly interested in the issues presented in this case, and it believes that its accumulated knowledge and experience may be of assistance to the Court.

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[1] Pursuant to Rule 37.3, the parties have consented to the submission of this brief. Letters of consent have been filed with the Clerk. No party authored this brief in whole or in part, and no person or entity, other than *Amicus Curiae*, has made a monetary contribution to the preparation or submission of this brief.

INTRODUCTION AND SUMMARY OF ARGUMENT

The Kentucky Court of Appeals held that Kentucky violated the so-called dormant Commerce Clause by exempting from Kentucky income tax the interest earned on bonds issued by Kentucky and its political subdivisions, while affording no such exemption to the interest earned on bonds issued by other states. According to the Kentucky court, "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." (Pet. App. A6.)

In reaching this conclusion, the Kentucky court expressly rejected the opposite conclusion reached by the Ohio Court of Appeals, which held that an identical Ohio tax exemption did not violate the dormant Commerce Clause doctrine because it did "not involve a taxation scheme whereby the citizenry of Ohio [was] provided with a competitive advantage over the citizenry of other states. Rather, the taxation scheme in the instant action benefits the state of Ohio itself." *Shaper v. Tracy*, 647 N.E.2d 550, 553 (Ohio Ct. App. 1994). The Kentucky court did not address the Ohio court's reasoning, but simply dismissed the decision on the ground that the "court failed fully to analyze the issue." (Pet. App. A7.)

The Kentucky court was unwisely dismissive of the Ohio decision. As this Court's recent decision in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 127 S. Ct. 1786 (2007), makes plain, a state necessarily retains broad discretion to adopt policies that favor itself, so long as those policies treat all private entities the same. Neither the Commerce Clause nor any other constitutional provision precludes a state from preferring its own interests to those of other states. Here, the Kentucky tax statutes treat all privately-issued bonds exactly the same, and

they properly treat bonds issued by other states as if they were issued by private entities. By favoring Kentucky bonds over those issued by other states, Kentucky does not discriminate against interstate commerce. *United Haulers* confirms that the Ohio court was correct in its determination that the dormant Commerce Clause doctrine prevents a state from preferring private domestic businesses over those based in other states, but it does not prevent the state from preferring itself in competition with other states or private entities.

The Kentucky Court of Appeals acknowledged that "[n]o one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds." (Pet. App. A10.) For that reason, Kentucky is free to pay whatever rate of interest it wishes, to whomever it wishes. That should have been enough for Kentucky to prevail in this case, but the Court of Appeals erred by refusing to acknowledge the economic reality of the Kentucky exemption, that is, the fact that the exemption is the functional equivalent of an additional interest payment, and it plays an essential role in Kentucky's activities as a market participant in the raising of capital through the selling of bonds.

The trial court, unlike the Court of Appeals, recognized that Kentucky, as a seller in the bond market, "clearly may pay a higher rate of interest to resident purchasers," and that providing a tax exemption for its own citizens is merely one way of achieving that result. (Pet. App. A18.) Theoretically, Kentucky could have done that, or it could have achieved the same financial result by other means, such as issuing tax credit coupons to all holders of its bonds, although the coupons would have had value only for Kentucky taxpayers. While those means would have been clearly constitutional, they would have been administratively burdensome and perhaps impracticable altogether. As the trial court

recognized, Kentucky should not be penalized for accomplishing a constitutionally proper objective in the most efficient way.

The Court of Appeals, on the other hand, applied a purely formal analysis, artificially dividing the state's bond activities into two distinct categories: selling bonds and taxing the income from bonds. By artificially separating the state's bond activities in this way, the Court of Appeals was able to assert that the taxing of income from bonds is "a primeval governmental activity" – one whereby the government "act[s] as a market regulator" and not as a market participant. (Pet. App. A10.) But that difference is one of form rather than substance and should not render the end result unconstitutional.

Finally, the Kentucky Court of Appeals failed to consider the importance of the tax exemption to the functioning of the bond market. Bonds issued by a particular state and its subdivisions are attractive investments for citizens of that state because of the double exemption from taxation – federal and state – which such bonds enjoy. Single-state bond funds, such as Nuveen's Kentucky Municipal Bond Fund, permit investors to enjoy that double exemption from taxation, while also achieving an appropriate diversity of investment portfolio. Investors do not have to invest large amounts of capital in a few bond issues, but can participate in a broad portfolio chosen by experienced fund managers. That spreads risk. It also permits smaller municipal issuers to have access to capital markets that they otherwise might not have, or that they might have only at greater cost. The importance and popularity of such single-state funds are well-demonstrated by the fact that there are 481 of them currently available in the market from a variety of entities,

including Nuveen. Investment Company Institute, 2007 INVESTMENT COMPANY FACT BOOK, 96, 98 (47th ed.).[2]

The present system has brought great benefits to the states, to political subdivisions, and to investors. The possible consequences of altering the current system cannot be fully comprehended at this point. Perhaps money will be reallocated among funds in the short term. Perhaps single-state bond funds will become less attractive investments in the long term. If so, some municipalities and other governmental units may experience higher costs; they may need to find other means of financing needed public improvements; or they may have to forego such projects altogether.

Even if the federal government had the power to set aside the current system under the Commerce Clause, that result could not be justified on the formalistic grounds invoked by the Kentucky Court of Appeals. Moreover, given the practical importance and far-reaching consequences of such a decision, it is one that should be made by Congress, and not by the courts. It certainly is not a decision for the courts to make through a further extension of the so-called dormant Commerce Clause.

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[2] Available at www.icifactbook.org.

ARGUMENT

I. THE DORMANT COMMERCE CLAUSE SHOULD NOT BE FURTHER EXTENDED TO PROHIBIT A STATE TAX-EXEMPTION THAT BENEFITS THE STATE BY FACILITATING THE SALE TO ITS CITIZENS OF ITS OWN BONDS AND THOSE OF ITS POLITICAL SUBDIVISIONS, BUT PROVIDES NO SIMILAR EXEMPTION FOR CORPORATE BONDS OR THOSE ISSUED BY OTHER STATES, AND TREATS ALL PRIVATE BUSINESSES ALIKE.

Kentucky, like other states, provides substantial benefits to itself, its political subdivisions, and, ultimately, to its citizens through the use of municipal bonds. Both the Commonwealth and its political subdivisions use bonds to generate funds for a wide range of capital projects. They use bonds to finance projects such as educational facilities, government buildings, modes of public transportation, hospitals, low-income housing, and entertainment venues. By holding that Kentucky's tax-exemption system violates the dormant Commerce Clause, the Kentucky court has reached out to make a determination normally thought to rest within the exclusive power of Congress, and has thrown up unnecessary, formalistic barriers in the face of Kentucky's efforts to provide funding for needed public projects through the sale of its own bonds, and those of its political subdivisions, to its own citizens.

The Kentucky court acknowledged that "[n]o one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds." (Pet. App. A10.) However, the Kentucky court struck down the Kentucky tax-exempt statute by treating Kentucky's tax-exemptions as wholly independent from its interest in selling its bonds and acquiring funds to finance its projects. In this way, the

Kentucky court justified characterizing Kentucky as a "market regulator," rather than as a "market participant." *Id.* But that misses the point: the tax exemption does not exist to serve any "market regulatory" purpose; its purpose is to assist Kentucky in its efforts to fund needed public improvements through the sale of its bonds in the market.

It is clear from this Court's precedents that when a state acts as a market participant, it enjoys the same power of contract as any other market participant and can therefore sell its products to whomever it chooses on whatever terms it is able to negotiate. *See Reeves v. Stake*, 447 U.S. 429 (1980). There are no limits on a state's ability to operate freely within the market. *Id.* at 437.

Kentucky's purpose in granting the tax exemption is to encourage the purchase of its bonds by its own citizens, who are likely to be most interested in, and knowledgeable about, local conditions.[3] Kentucky simply wishes to make its investments more attractive to this market. It has chosen to do so by providing a tax exemption. It could have achieved the same financial result by authorizing a higher rate of interest on those bonds held by its own citizens, or by issuing bonds with a tax credit coupon attached, which it could give

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[3] Bonds may be issued by the state itself or by special and general units of local government. Even when bonds are issued by units of local government, however, the bonds are issued pursuant to delegated authority. Such authority is typically conferred by state constitution, statute, or charter, and it is commonly held that such authority may be conferred only by language that leaves no reasonable doubt as to the sovereign's intention to grant it. *See* 15 Eugene McQuillin, Municipal Corporations, §§ 43:22, 43:24 (3d ed. 2005). Such is the case in Kentucky, where Section 158 of the Constitution provides that, "Nothing shall prevent the issue of renewal bonds, or bonds to fund the floating indebtedness of any city, county, or taxing district." Ky. Const. § 158. Moreover, it is the state in every case that subsidizes the bonds by providing the exemption from taxation.

to everyone, but which would provide a real benefit only to Kentucky taxpayers. As a matter of constitutional law, either of these alternatives would be permissible.

As a practical matter, however, both alternatives would impose substantial and unnecessary administrative costs, compared to simply checking a box on an income tax return form that the taxpayer must file and the state must process in any event. Indeed, neither of these alternatives would be feasible in practice. While these alternatives might work, at least theoretically, with respect to bonds purchased and held by individual investors, it is difficult to see, as a practical matter, how the state would assure itself of the citizenship of current owners of bonds that were traded in the market. It is equally difficult, as a practical matter, to see how a coupon system could be designed and administered to accommodate changes in ownership. If those alternatives were at least theoretically feasible in the case of individual investors who wished to purchase individual bonds, it is clear that they could not work, even theoretically, for investors who sought to invest in a portfolio held by a single-state fund. Such approaches are simply inconsistent with the nature of funds.

A state's felt need to avoid such unnecessary transaction costs, and perhaps insurmountable practical barriers, should not be deemed sufficient to transform a constitutionally permissible action into one that is unconstitutional. Such interference in a state's decision as to how it will structure its marketplace transactions is unwarranted under the guise of the dormant Commerce Clause doctrine. In *Reeves*, this Court declined to involve itself in a state's decision regarding sales from a cement facility, finding that "[s]uch a holding . . . would interfere significantly with a State's ability to structure relations exclusively with its own citizens. It would also threaten the future fashioning of effective and creative programs for solving local problems and distributing

government largesse. A healthy regard for federalism and good government renders us reluctant to risk these results." *Ia.* at 441.

Applying the so-called dormant Commerce Clause in such a rigid and mechanical way not only extends that doctrine beyond any defensible limits, but effectively forecloses Kentucky from acting most efficiently to accomplish its legitimate and important purpose of selling bonds to its own citizens, and rewarding them appropriately for supporting needed public works. Moreover, Kentucky is not alone in this respect. Each state is fully capable of raising needed funds in the same way, and providing favorable tax treatment to in-state purchasers of its own bonds. Thus, there is no discrimination against interstate commerce; there is nothing for the dormant Commerce Clause doctrine to remedy; and affirmance of the decision below would simply lead to economically absurd results.

Decisions regarding state public financing and how states participate in the bond market are matters of policy best left to the lawmaking branches of state government. *See Helvering v. Gerhardt*, 304 U.S. 405, 427 (1938) (Black, J., concurring) ("[t]he genius of our government provides that, within the sphere of constitutional action, the people - acting not through the courts but through their elected legislative representatives - have the power to determine as conditions demand, what services and functions the public welfare requires.").

Moreover, to the extent that state choices in this area are thought to raise issues under the Commerce Clause, those issues should be resolved by Congress, not the courts. In *Reeves*, this Court noted that "the competing considerations in cases involving state proprietary action often will be subtle, complex, politically charged, and difficult to assess under traditional Commerce Clause analysis . . . [thus] the

adjustment of interests in this context is a task better suited for Congress than this Court." *Reeves*, 447 U.S. at 439.

In sum, the application of the so-called dormant Commerce Clause to strike down this type of tax-exemption, which is prevalent throughout the country, would be unjustified and ill-advised.

II. EXEMPTING STATE-ISSUED BONDS FROM STATE TAXATION SERVES IMPORTANT PUBLIC PURPOSES IN THAT IT ENCOURAGES STATE CITIZENS, WHO HAVE A SPECIAL INTEREST IN AND KNOWLEDGE OF LOCAL CONDITIONS, TO MAKE INVESTMENTS IN SUPPORT OF STATE AND LOCAL PROJECTS; IT PERMITS SMALL, CREDIT-WORTHY ISSUERS TO GAIN ACCESS TO THE CAPITAL MARKETS FOR NEEDED PROJECTS; AND IT REDUCES THE COST TO THE STATE AND ITS POLITICAL SUBDIVISIONS OF ISSUING BONDS.

Municipal bonds are used for a wide variety of public purposes. State and local governmental units throughout the country issue bonds to fund everything from large-scale public works projects to smaller, more localized needs. For example, Nuveen's Kentucky Municipal Bond Fund includes bonds from large issuers such as the Louisville and Jefferson County Metropolitan Sewer District, an issuer which currently has over $1 billion in municipal debt outstanding, to bonds issued by smaller issuers, such as Henderson County Residential Facilities, Pleasant Pointe Apartments, which financed the rehabilitation of a senior living facility and has only $3.5 million currently outstanding.[4] The use of debt in the form of bonds to finance public works is often

[4] *See* Form N-Q for Nuveen Multistate Trust IV, filed April 27, 2007 by Nuveen Investments, Inc., available via EDGAR at www.sec.gov.

preferable because it distributes the cost of projects with a long useful life, *i.e.*, new schools, roads, or sewer systems, across both current and future users. Robert S. Amdursky and Clayton P. Gillette, MUNICIPAL DEBT FINANCE LAW, § 1.1.3 at 10-11 (1992). On the other hand, using general tax revenues obtained at the time of the project would allow subsequent users to receive the benefit of the project without paying for the cost.

The importance of the municipal bond market to the financing of state and local government is difficult to overstate. According to the Federal Reserve, there was more than $2 trillion in state and local bonds outstanding as of March 2007. Approximately $439.2 billion in municipal assets are held by open-end and closed-end funds, making these funds the largest category of holder. *See* Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States: Flows and Outstanding First Quarter 2007* (June 7, 2007).[5]

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[5] Available at www.federalreserve.gov. Research also suggests that participation in the municipal bond markets encourage good government. Recent scholarly studies show that governments that run persistent deficits are punished in the form of higher bond costs, while governments that exercise fiscal discipline are rewarded with lower borrowing costs. *See* Morris Goldstein and Geoffrey Woglom, *Market-based Fiscal Discipline in Monetary Unions*, in ESTABLISHING A CENTRAL BANK 228-260, 232 (Matthew B. Canzoneri, et al., eds. Cambridge 1992). The same holds true for governments plagued with political corruption. *See* Alexander W. Butler, et al., Corruption, Political Connections, and Municipal Finance 26 (June 19, 2007) (unpublished manuscript, available at SSRN: http://ssrn.com/abstract=972471). The bond market, then, provides the public with important information about the quality of its governmental units.

A. The Development of Municipal Bond Funds and Single-State Bond Funds has Benefitted the Market and its State Participants.

Although the income from municipal bonds has always been exempt from federal taxation, *see* 26 U.S.C. § 103(a), it was not until the passage of the Tax Reform Act of 1976 that bond funds could pass along this benefit to fundholders. *See* 26 U.S.C. § 852(b)(5); Thomas S. Harman, *Emerging Alternatives to Mutual Funds*, 1987 DUKE L. J. 1045, 1052 (1987). That was a significant development because many consider bond funds to be preferable to individual bonds in that they permit an investor to diversify his or her portfolio and limit risk.

The 1976 change in federal tax law spurred the creation of funds specializing in municipal bonds. Nuveen started its first municipal bond fund in 1976 and now offers more than 130 different funds holding more than $50 billion in assets. Nuveen's dramatic increase in assets under management and the growth in the number of its municipal bond funds during the past 30 years reflects the general market trend during that period. In 1980, only 1.6% of municipal bonds were held by funds; by 1999, approximately 35% of municipal bonds were held by funds. The Bond Market Association, FUNDAMENTALS OF MUNICIPAL BONDS 17 (5th ed. 2001).

Municipal bonds and bond funds are thought to be appropriate investment vehicles for some taxpayers because of the effect of the exemption from federal income taxation. The desirability of such investments is enhanced in many states (particularly in jurisdictions with high tax rates) by an additional state income tax exemption. Single-state municipal bond funds permit investors to take advantage of this double tax-exemption benefit, while also diversifying their investments and spreading risks. For this reason, single-state

bond funds have developed as an important subset of the municipal bond fund market.[6]

In 1984, there were only 37 single-state municipal bond funds holding approximately $4.78 billion in assets. Investment Company Institute, 2007 INVESTMENT COMPANY FACT BOOK at 96, 98. By 2006, there were 481 single-state municipal bond funds holding more than $154 billion in assets. *Id.*

As the single-state municipal bond fund market has grown, it also has become increasingly specialized, so that investors can now choose among funds specializing in different types of bonds issued by the same state. Jerry Webman, *Managing Single-State Municipal Bond Funds*, in THE HANDBOOK OF MUNICIPAL BONDS, 339-350, 340 (Susan C. Heide, et al., eds, 1994). For example, Nuveen offers three different State Municipal Bond Funds that include only California bonds: California, California High Yield, and California Insured.

The existence of a robust market for municipal bond funds greatly benefits the municipal bond market for two primary reasons. First, the entry of large, sophisticated bond funds into the municipal bond market ameliorates two of the chief challenges that face the municipal bond market: limited information and liquidity.

Unlike large corporations, which typically issue shares and debt instruments that are nationally-traded and nationally-regulated, state and local governments issue bonds that are generally traded in less centralized markets and are less intensively regulated by the Securities and Exchange

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[6] Single-state or state-specific municipal bond funds invest in bonds issued by a particular state. National municipal bond funds are not limited to the bonds of a particular state.

Commission than corporate issues.[7] With respect to the bonds themselves, therefore, there is less information that is readily available in the market, and the transaction costs of acquiring information are greater than they are in the case of corporate equity and debt instruments. *See* Richard C. Green, et al., *Financial Intermediation and the Costs of Trading in an Opaque Market*, THE REVIEW OF FINANCIAL STUDIES, Vol. 20, No. 2 at 276, 308 (2007).

The municipal bond market is also relatively illiquid, when compared to the equity markets. *See* Lawrence E. Harris and Michael S. Piowar, *Secondary Trading Costs in the Municipal Bond Market*, THE JOURNAL OF FINANCE, Vol. 61, No. 3 at 1361 (2006). One significant consequence of this relatively lower liquidity is that, at the retail level, "estimated trading costs are smaller for the bonds of large issuers than of small issuers." *Id.* at 1392. However, bond funds, as institutional investors, are able to trade in larger quantities, and thus spread information costs over a larger number of transactions. The net result is that institutional-size research and trades are less costly. *Id.* at 1393.

Municipal bond funds, like funds holding equity securities, facilitate investment by small investors. Funds lower trading costs and permit investors to make investment decisions without having to undergo the expense of researching individual issues. That level of research is done by the funds, and more informed investment decisions are therefore possible. In addition, of course, funds also diversify risk by spreading it across a greater number of investments.

Second, state-specific bond funds also reduce some of the cost-disparities between small and large issuers because they

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[7] The Securities Act of 1933 exempted municipal bonds from its registration statement requirements. *See* 15 U.S.C. § 77c(a)(2).

create demand for bonds on a geographic basis, as well as on purely price and cost bases. The creation of this demand benefits small, credit-worthy issuers whose bond issues might be overlooked in a broader market, or which might at least experience greater relative costs in being brought to market. Thus, a broader cross-section of large and small communities will be able more efficiently to finance projects appropriate to their sizes and resources. In other words, there is a demand for Kentucky bonds, whether from large or small issuers, because large funds have created Kentucky-specific funds that maximize tax benefits for Kentucky residents. The same is true, of course, for other single-state funds throughout the nation. Absent the double exemption, a major market motivation for single-state funds would disappear, however, and opportunities for small issuers would be lessened as a result.

In sum, the participation of professionally-managed municipal bond funds in the bond market has a net positive effect on the market itself, as well as for the issuers of the bonds. Furthermore, the presence of state-specific municipal bond funds assists small issuers by increasing demand for their bonds.

B. Eliminating the State's Power to Exempt Its Own Bonds from Taxation While Taxing Other States' Bonds Will Cause Uncertainty in the Municipal Bond Market.

When a state foregoes its right to tax municipal bond income, the state effectively provides a subsidy for the projects deemed necessary or desirable by its political subdivisions. The state could have secured this revenue for itself, but it has decided to forego this revenue so that its political subdivisions can raise money at a lower cost to accomplish their projects. Of course, each state is capable of making such decisions, and each state may decide for itself

whether it wishes to make that contribution to the well-being of its local governmental units.

The present system has provided substantial benefits to the states, to their political subdivisions, and to the citizen-investors who choose to invest in this way in projects thought desirable by their elected officials. The precise effects of denying each of the states the power to exempt income from its own bonds, and those of its subdivisions, from taxation, without also exempting income from the bonds of its sister states, cannot now be predicted with a high degree of accuracy, but such a dramatic change in the current legal landscape will undoubtedly affect both the market and the operations of state and local government throughout the country.

The current structure of the municipal bond fund market is predicated on the long-held understanding that states may choose to create a tax-exemption applicable only to their own bonds. At present, single-state municipal bond funds are economically sensible because they provide investors with an after-tax return that reflects the double tax exemption (from federal and state income tax) accorded on the income earned by the portfolio. Such funds also provide an after-tax return that is at least comparable to that available from national municipal bond funds. The importance and popularity of such single-state bond funds is well-demonstrated by the fact that 481 such funds currently exist in the market. *See* Investment Company Institute, 2007 INVESTMENT COMPANY FACT BOOK at 98.

Any conceivable alteration of the state income tax exemption based on the reasoning of the decision below necessarily would alter the economics of bond fund investments, with the potential to shift billions of dollars in value. The state would then have to choose whether, in light of the new economic situation, it would (1) pay a higher rate

of interest to state residents to offset the taxes, (2) require state residents to pay the taxes, or (3) forego collecting taxes on all municipal bonds, regardless of the state of origin.

The first option could not be applied to existing funds. In addition, to the extent that it could be applied at all, it would impose higher costs on the state in the form of administrative expenses. Most important, the first option would not work in the case of bonds held by funds, and it is difficult to see how it could apply to bonds held by individuals, to the extent that such bonds are traded and change ownership. The second option makes municipal bonds less attractive to in-state investors because it reduces the after-tax return on investment (and puts the balance of the reduction back in the state's pocket). The third option would require the state to grant a subsidy, not just to its own political subdivisions, as it does currently, but to all of its sister states and their political subdivisions.

At this point, it is probably impossible to say precisely what effects would follow if the decision of the Kentucky Court of Appeals were to be affirmed. Clearly, single-state funds would become relatively less desirable to in-state investors because either the current double exemption would no longer exist, or it would apply categorically to the bond issues of all states. Both the need for, and the value of, state-specific funds likely would decrease. Whether the value of national funds would increase to the same extent is open to question. Of course, these observations apply only to existing funds, and to the possible readjustments that would be applicable to them.

The effect of such a ruling on new funds is even less clear. Perhaps money will simply be allocated among future municipal funds in different ways. Perhaps national funds will benefit, while state-specific funds will suffer because a major market motivation for single-state funds will

disappear. But that assumes that a constant amount (or percentage) of money will continue to be allocated to municipal bond funds, as opposed to other investments. That may or may not be the case. It may be that municipal bonds will suffer as a class, and that investors will choose to invest their money in other ways.

The reality, of course, is that any such reallocation of investment priorities would cause dislocations in the existing capital market, but, even more important, any such reallocation could also increase costs for issuers. It might even deprive some units of local government of any access to funds that they otherwise would have been able to raise for needed improvements. That would cause a serious dislocation, not only to capital markets, but also to the plans and priorities of local government units. Frugal governmental units, which have been planning needed improvements for many years, may suddenly find themselves with more limited access to the needed resources. If there is a decline in the amount of money available for investment in state and local government bonds, state and local governments will either have to do without the improvements they have thought necessary or desirable, or they will have to find alternative methods for financing them. In today's world, when many clamor to cut taxes and government expenditures, that would present a clearly unnecessary challenge.

One thing is certain. Whatever changes are likely, the changes are most likely to have the greatest effect on the smaller issuers that currently benefit in a special way from the availability of single-state municipal bond funds. As previously noted, issuer costs are relatively higher for smaller, credit-worthy issuers. One virtue of the single-state municipal bond fund is that it allows small issuers access to a larger pool of investors through bond funds that choose

bonds based, at least in part, on geography. Thus, a small, creditworthy issuer in Kentucky will be an attractive investment to a bond fund specializing in Kentucky-issued bonds, even though it may be too small to be noticed by a nationally-focused fund. If the tax incentive to create and maintain single-state bond funds is eliminated, however, the geographic component of the small issuer's value will be eliminated. The small issuer must then compete with larger issuers, which have the benefit of economies of scale and therefore experience lower transaction costs. To compensate for the cost differential, the small issuer will be required to offer greater returns in the form of higher interest rates. The net effect, then, is either to increase the entry costs for small issuers or to prevent the small issuer from entering the market altogether.

Currently, small issuers throughout the country play a significant role in the single-state bond market. For the first half of 2007, for example, Kentucky issuers priced 106 municipal bond deals, only 39 (or 37%) of which were for amounts greater than $10 million. Eliminating the state tax-exemption that makes the single-state bond fund attractive to in-state investors will likely impose significantly increased costs on the small issuers.

In sum, the precise effects of eliminating the power of states to exempt their own bonds (and only their own bonds) from in-state taxation cannot be predicted with certainty, but affirming the Kentucky court's opinion certainly will cause substantial dislocation in the $2 trillion municipal bond market. Even if that result were within the power of the federal government to accomplish, the wisdom of doing so would properly be a matter for Congress to decide, after extensive study and debate. It is not something to be done by this Court's further extension of the so-called dormant Commerce Clause doctrine. Too much is at stake for the

vitality of our state and local governments, and too great is the possibility of unintended consequences in this complex area of state and local finance and governance.

CONCLUSION

The decision of the Kentucky Court of Appeals should be reversed.

Respectfully submitted,

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Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,

Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

AMICUS CURIAE BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE*[1]

The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

SIFMA and its members are actively involved in all aspects of the municipal bond markets. Accordingly, SIFMA has a particular interest in the legal, regulatory and market practice issues raised in this case. Collectively, its membership accounts for approximately 90% of the nation's municipal bond underwriting and trading activity by volume, which represented an estimated $5 trillion in municipal bonds, including appropriation-backed bonds and other municipal securities, in 2006. SIFMA also has published a Standard Agreement Among Underwriters for use in municipal underwritings, as well as other standardized documentation for bond market transactions.

In view of the role of SIFMA's members in the underwriting, purchase, and sale of public debt by the States and their subdivisions, SIFMA has a strong interest in the constitutional question Petitioners raise regarding the

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[1] No counsel for any party authored this brief in whole or in part. Only the Securities Industry and Financial Markets Association and its members, through payment of their membership fees, made any monetary contribution to the preparation or submission of this brief. This brief is being filed with the consent of the parties.

treatment of municipal bonds under State tax laws. SIFMA submits this brief in support of Petitioners and to provide the Court with a practical understanding of the effect that a decision affirming the ruling of the Kentucky Court of Appeals would have on the municipal bond market.

STATEMENT OF THE CASE

Kentucky does not tax the interest earned by its residents on municipal bonds issued by the Commonwealth or its political subdivisions, but it does tax the interest earned by its residents on municipal bonds issued by other States and their political subdivisions. See Ky. Rev. Stat. Ann. § 141.010(9), (10).

Respondents are Kentucky residents who paid income tax on interest earned on obligations of States, and political subdivisions thereof, other than Kentucky. Respondents filed suit in the Jefferson County Circuit Court, claiming that Kentucky's income tax scheme violated the Commerce Clause of the United States Constitution by discriminating against the holders of obligations issued by sister States and/or their political subdivisions by imposing a tax on income earned on such obligations greater than that imposed upon interest earned on obligations of the Commonwealth. They sought declaratory and injunctive relief, as well as refunds for the taxes they paid.

The Jefferson Circuit Court granted summary judgment in favor of Petitioners and relied on the market participant doctrine in ruling that the Kentucky tax scheme does not violate the Commerce Clause. See, *e.g.*, *Reeves, Inc.* v. *Stake*, 447 U.S. 429 (1980); *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794 (1976). Specifically, the court found that "[w]hen a state issues municipal bonds, it participates in the bond market by supplying bonds in the market and paying interest on those bonds." Pet. App. at 18. Therefore, the court found, Kentucky "clearly may pay a higher rate of interest to resident

purchasers based upon theories of distributing state created benefits and market participation." *Id.*

Respondents appealed to the Kentucky Court of Appeals, which reversed, holding that "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." Pet. App. at 6. Petitioners filed a motion for discretionary review of the Court of Appeals decision but the Kentucky Supreme Court denied the motion.

The Court granted a petition for certiorari on May 21, 2007.

SUMMARY OF THE ARGUMENT

In deciding this case, the Court should follow the reasoning set forth in its recent opinion in *United Haulers Association, Inc.* v. *Oneida-Herkimer Solid Waste Management Authority*, 127 S. Ct. 1786 (2007) (plurality opinion), where it held that a municipal trash flow control ordinance did not violate the dormant Commerce Clause because, although it granted a monopoly to a local trash processing facility to the exclusion of privately-owned trash processing facilities in other States, the ordinance was not discriminatory as it was designed to benefit a "clearly public facility, while treating all private companies exactly the same." *Id.* at 1795. *United Haulers* demonstrates that the dormant Commerce Clause was not intended to forbid statutes designed to protect a State's own public interests, even if an effect of such statutes comes at the expense of the interests of private market participants.

The Kentucky statute at issue here is even further removed from the purview of the Commerce Clause because it provides for preferential tax treatment of bonds issued by the State and its own municipalities over other States and their municipalities. Respondents do not claim that the Kentucky statute elevates private companies within Kentucky over private companies in other States; the statute simply prefers

one State's municipal bonds over another State's municipal bonds. That is, the statute benefits Kentucky governmental entities by giving its residents an incentive to purchase Kentucky State and local government bonds at lower interest rates than the same investors would require for purchase of the bonds of other States due to the differing tax treatments. Such conduct does not violate the Commerce Clause.

Stare decisis also strongly supports reversal of the court below. In *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881), the Court upheld a statute that allowed the State of Maryland to tax its residents on the registered public debt of *other* States, even where the debt was exempt from taxation by the debtor State, while not taxing public debt of Maryland. The Court held that there was "*no provision of the Constitution* of the United States which prohibits such taxation," *id.* at 594 (emphasis added), and "the States are left free to extend the comity which is sought, or not, as they please," *id.* at 595. The Court thus rejected the argument of petitioners that a constitutional prohibition was necessary to "avoid[] the danger of reciprocally hostile legislation by the several States against the credit of their neighbors." *Id.* at 594. *Stare decisis* counsels judicial respect for a court's earlier decisions and compels adherence to the long-standing precedent announced in *Bonaparte*. Adherence to precedent is especially warranted here, where the municipal bond market and the accompanying State tax laws have developed over several decades consistent with this century-old decision. Accordingly, the Court should reverse the decision of the court below.

An affirmance, on the other hand, may result in instability and price uncertainty in the national municipal bond market because forty-two other States have laws that, like Kentucky, treat bonds issued by other States less favorably from a tax standpoint than in-State bonds. States will be forced to overhaul their tax schemes by either exempting interest on all municipal bonds or taxing interest on all municipal bonds,

which in some States may require significant legislative or even state constitutional amendments. If the municipal bond tax incentive evaporates, the demand for such bonds may likewise vanish, thus drying up a major source of funding for State projects. Moreover, States – and possibly others – may face potential litigation.

Investors likewise may feel the effect of the unsettled market if the Court declares that the Kentucky tax scheme is unconstitutional. Investors may face price uncertainty on outstanding municipal bonds and potential litigation with market participants, at potentially significant expense, to recover taxes paid on extraterritorial bonds under a tax scheme that is deemed unconstitutional. If States opt to tax interest on all bonds, on the other hand, investors may encounter attempts by States to recover previously forgone tax revenues. Such a result would be particularly disruptive for investors who buy fixed-income, tax-advantaged bonds precisely for their predictable income streams, such as retirees.

Finally, the market as a whole likely will suffer through an initial period of "price discovery," during which issuers and other market participants may be unsure of demand for municipal bonds and may be forced to value bonds through trial and error. This market turmoil may force market makers to buy back municipal bonds, which may cause inventory to swell to unusually high levels, further depressing prices, until the full effect of the decision is absorbed.

ARGUMENT

I. THE COURT SHOULD REVERSE THE RULING OF THE KENTUCKY COURT OF APPEALS ON THE BASIS OF THE REASONING OF *UNITED HAULERS.*

The statute at issue here is similar to the ordinance recently upheld in *United Haulers Association, Inc.* v. *Oneida-*

Herkimer Solid Waste Authority, 127 S. Ct. 1786 (2007) (plurality opinion). In *United Haulers*, the Court held that a municipal trash "flow control" ordinance did not discriminate against interstate commerce because, although it required that trash haulers deliver trash to a processing plant owned and operated by the local government to the exclusion of privately owned trash processing facilities in other States, the ordinance "advance[d] a legitimate local purpose," *id.* at 1793, and benefited a "clearly public facility, while treating all private companies exactly the same," *id.* at 1795.

Although the ordinance in *United Haulers* is not identical to the Kentucky statute at issue here, the Court's reasoning compels the same result. The Court found that the flow control ordinance was not the kind of "economic protectionism" that the dormant Commerce Clause was intended to prevent. *Id.* at 1796 (quoting *Wyoming* v. *Oklahoma*, 502 U.S. 437, 454 (1992)). Indeed, the Court reasoned that "[l]aws *favoring local government*, by contrast, may be directed toward any number of legitimate goals unrelated to protectionism." *Id.* (emphasis added).

The Kentucky tax statute is even further removed from the type of "protectionist" legislation that the Constitution forbids than the flow control ordinance in *United Haulers*. In this case, Kentucky provides for preferential tax treatment of its own municipal bonds over the municipal bonds of other States. The Kentucky statute does not discriminate "in favor of *private* enterprise." *Id.* at 1794. Rather, Kentucky prefers its municipal bonds over those of other *States and municipalities*. As the Court noted in *United Haulers*, "States and municipalities are not private businesses – far from it." *Id.* at 1795. Unlike the private interests disfavored by the *United Haulers* flow control ordinance, States whose bonds receive less favorable tax treatment under the Kentucky statute are on equal footing with the Commonwealth of Kentucky. Any other State has the power to – and the vast majority of States, in fact, do – treat municipal bonds issued

within Kentucky the same way Kentucky treats bonds issued within those States, *i.e.*, by taxing their residents on interest earned on out-of-State bonds. So long as a State is not preferring one group of commercial interests over another group of commercial interests, "[t]he dormant Commerce Clause is not a roving license for federal courts" to mandate what conduct is appropriate for State and local governments. *Id.* at 1796. The Constitution simply was not intended to prevent States from preferring their own municipal bonds over the municipal bonds of other States. Accordingly, nothing in the Commerce Clause prohibits Kentucky's preferential tax treatment for municipal bonds issued in Kentucky.

To the extent the Commerce Clause applies at all, the Kentucky statute also satisfies the "burden" test of *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). The *Pike* test is reserved for statutes that serve legitimate local concerns and have nothing more than an incidental effect on interstate commerce. See *United Haulers*, 127 S. Ct. at 1797. Under the *Pike* test, the Court will uphold a statute like the Kentucky tax scheme "unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits." *Pike*, 397 U.S. at 142; see also *United Haulers*, 127 S. Ct. at 1797. The Kentucky tax statute clearly serves a legitimate – indeed, compelling – local concern: providing incentives to Kentucky's citizens to invest in the bonds that secure financing for local municipalities at lower interest rates. This financing, in turn, provides the citizens with the necessary infrastructure to ensure the community's health and welfare. State and local governments use the money generated by these bonds to support a broad array of traditional government activities, including education programs, health services, and public transportation systems. Bonds also help to fund specific projects, such as building new community facilities, expanding highways, and improving local security initiatives. Because any possible

burden imposed by the Kentucky tax scheme upon interstate commerce could not possibly outweigh the compelling public benefit it serves, it is unnecessary to determine whether the statute imposes any incidental burden on interstate commerce. *United Haulers*, 127 S. Ct. at 1797.

SIFMA recognizes that preferential tax policies nonetheless may raise Commerce Clause concerns regarding programs less central to public functions than the issuance of tax-advantaged public debt. Accordingly, SIFMA respectfully submits that the Court's decision should be narrowly limited to the context of tax preferences for municipal bonds, and should not prejudge discrimination in other areas that involve greater participation by private market participants. Such a limited ruling is consistent with the Court's longstanding tradition of deciding the case or constitutional issue before it on the narrowest ground available. See, *e.g.*, *Liverpool, N.Y. & Phila. S.S. Co.* v. *Emigration Comm'rs*, 113 U.S. 33, 39 (1885) (the Court shall not "formulate a rule of constitutional law broader than is required by the precise facts to which it is to be applied"); *Ashwander* v. *Tennessee Valley Auth.*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring) ("The Court will not pass upon a constitutional question although properly presented by the record, if there is also present some other ground upon which the case may be disposed of.").

II. *STARE DECISIS* SUPPORTS REVERSAL.

The decision of the Kentucky Court of Appeals overturns a widespread network of statutes and governmental programs that have developed based on settled law since 1881. In *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881), the Court upheld a State's ability to tax interest earned on municipal bonds issued by other States. The tax scheme deemed constitutional in *Bonaparte* provided for the same disparate treatment allowed under the Kentucky statute.[2] The Court

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[2] The Maryland statute upheld in *Bonaparte* provided for taxation of interest on bonds issued by other States, but made no such provision for

considered "whether the registered public debt of one State, exempt from taxation by the debtor State, or actually taxed there, is taxable by another State when owned by a resident of the latter State." *Id.* at 594. The statute at issue in *Bonaparte* was challenged under both the Constitution as a whole (without expressly mentioning the Commerce Clause) and the Full Faith and Credit Clause. The challenge based on the Constitution as a whole was phrased in terms of the burden on other States and discrimination between the States. *See id.* (referring to petitioner's argument that the tax fosters "sectional jealousies and antagonisms" and "reciprocally hostile legislation by the several States against the credit of their neighbors"); Brief for Plaintiff in Error at 13, *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881) (No. 172) (referring to "harass[ing] and imped[ing] each other's administrative instrumentalities"). The Court ruled that "*no provision* of the Constitution . . . prohibits such taxation." *Bonaparte*, 104 U.S. at 594 (emphasis added). The Court explained that "the States are left free to extend the comity which is sought, or not, as they please." *Id.* at 595.

The Court should not lightly overturn 126 years of practice under *Bonaparte*. *Stare decisis* "commands judicial respect for a court's earlier decisions" and compels the Court to adhere to the long-standing precedent announced in *Bonaparte*. *Randall* v. *Sorrell*, 126 S. Ct. 2479, 2489 (2006) (plurality opinion) ("*Stare decisis* . . . avoids the instability

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bonds issued by the State of Maryland ("all bonds made by any corporation or ***by any other State***, or by any territory belonging to residents of this State . . . shall be liable to . . . taxation"). *See* Maryland Act of 1876, ch. 260, § 1 (quoted in Brief for Plaintiff in Error at 1-2, *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881) (No. 172) (emphasis added). Likewise, the Kentucky statute at issue here provides that "interest income derived from obligations of sister states and political subdivisions thereof," Ky. Rev. Stat. Ann. § 141.010(10)(c), must be added back to the gross income as defined by the federal tax code, which "does not include interest on any State or local bond," 26 U.S.C. §§ 61(a), 103(a) & (c)(1); 26 C.F.R. § 1.61-7(b).

and unfairness that accompany disruption of settled legal expectations."); see also *Itel Containers Int'l Corp.* v. *Huddleston*, 507 U.S. 60, 79 (1993) (Scalia, J., concurring) (the principal purposes of *stare decisis* are "to protect reliance interests and to foster stability in the law"). Indeed, adherence to precedent is the norm; departure from it is exceptional. See *Arizona* v. *Rumsey*, 467 U.S. 203, 212 (1984) (noting that departure from *stare decisis* requires "special justification"). *Stare decisis* applies to a decision's rationale, and not merely its narrowest "specific holding." See, *e.g.*, *Carey* v. *Musladin*, 127 S. Ct. 649, 655 (2006) (Stevens, J., concurring) (*stare decisis* includes "explanatory language" for the Court's ruling even if "such guidance . . . may not have been strictly necessary as an explanation of the Court's specific holding"); *Seminole Tribe* v. *Florida*, 517 U.S. 44, 67 (1996) ("When an opinion issues for the Court, it is not only the result but also those portions of the opinion necessary to that result by which we are bound."); *County of Allegheny* v. *ACLU*, 492 U.S. 573, 668 (1989) (Kennedy, J., concurring and dissenting) ("As a general rule, the principle of *stare decisis* directs us to adhere not only to the holdings of our prior cases, but also to their explications of the governing rules of law.").

In this case, adherence to precedent is especially warranted where the municipal bond market, and the accompanying State tax laws, have developed over many decades based on this century-old decision. Virtually every market participant is aware of the tax advantage approved in *Bonaparte*, as demonstrated by the more than 530 State-specific municipal bond funds currently available.[3] That this principle is considered settled law also may be seen in the offering documents delivered in connection with the issuance of tax exempt bonds. Each offering memorandum contains a tax

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[3] *See* Tom Herman, *Kentucky Suffers Setback in Muni-Bond Tax Case*, Wall Street J., Sept. 6, 2006, at D2.

section that describes the material tax consequences of owning such a bond. Until *certiorari* was granted in this case, the tax section in the majority of offering memoranda contained a simple statement, without reservation, that the interest on the bonds being issued is exempt from the income tax imposed by the issuing State.

Where, as here, the precedent "has engendered substantial reliance and has become part of the basic framework of a sizable industry," the Court should abide by the ruling in *Bonaparte* and uphold the Kentucky statute. *Quill Corp.* v. *North Dakota ex rel. Heitkamp*, 504 U.S. 298, 317 (1992); see also *Hilton* v. *South Carolina Pub. Rys. Comm'n*, 502 U.S. 197, 203 (1991) (declining to overrule worker compensation precedent where doing so "would require these States to reexamine their statutes, meanwhile putting at risk all employees and employers who have been acting on the assumption that they are protected in the event of injuries caused by an employer's negligence").[4]

III. AFFIRMING THE DECISION OF THE KENTUCKY COURT OF APPEALS MAY RESULT IN INSTABILITY AND PRICE UNCERTAINTY IN THE MUNICIPAL BOND MARKETS.

If the Court affirms the ruling of the Kentucky Court of Appeals, the extent of the effect on the municipal bond market will be unpredictable. The municipal bond market is enormous, as this form of public finance has been widely used in recent decades. As of first quarter 2007, there are approximately $2.5 trillion in State and local municipal bonds outstanding.[5] The size of this market can be demonstrated by

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[4] As above, *supra*, at 8, any ruling based on *stare decisis* should not address whether *Bonaparte* would apply to matters other than municipal bonds.

[5] *See* Federal Reserve, *Flow of Funds Accounts of the United States*, tbl.L.211, at 89 (June 7, 2007) *available at* http://www.federalreserve.gov/releases/Z1/.

the number of investors who filed tax returns reporting tax exempt interest on municipal bonds, which was roughly 4.4 million in 2004.[6] The Internal Revenue Service estimates that the interest earned on municipal bonds in that same year was $52 billion.[7]

Forty-two other States have laws that, like the Kentucky statute at issue here, give preferential tax treatment to in-State bonds over bonds issued by other States and their municipalities.[8] In particular, thirty-eight States currently impose income tax on interest earned on out-of-State bonds, while exempting from tax interest earned on in-State bonds.[9] Investors in municipal bonds rely on the preferential tax treatment given to in-State bonds; indeed, their tax advantage is a substantial selling point for such bonds. A decision that Kentucky's statute is unconstitutional may affect State budgets and tax schemes, cause confusion and uncertainty among investors, and lead to disruption in the municipal bond market.

Impact on the States

The impact of a change in the *status quo* would be borne significantly by the States. If the Kentucky statute is held to violate the Commerce Clause, a State that currently exempts interest earned on only its own municipal bonds will be compelled to comply with the Constitution by either

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[6] *See* Internal Revenue Service, SOI Tax Stats - Individual Statistical Tables by Size of Adjusted Gross Income (All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items) tbl.1.2 (2004), *available at* http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html (main page).

[7] *Id.*

[8] *See* Jerry Solomon & Hannah O'Brien-Rupert, Bear Stearns, *The Kentucky Department of Revenue* v. *Davis* 5 (June 22, 2007).

[9] *See* Petition for Cert. at 7-8, *Kentucky Dep't of Revenue* v. *Davis*, No. 06-666 (U.S. filed Nov. 9, 2006).

exempting interest on all municipal bonds, regardless of which State issued them, or taxing interest earned on all municipal bonds, including its own. Regardless of which approach a particular State adopts, the result will require significant changes to that State's tax program and may cause great disruption to its budgets.

If a State chooses to tax interest on all municipal bonds, it may even need to overhaul its governing laws. For example, California's Constitution provides a tax exemption for municipal bonds issued by the State or any local government within the State.[10] Accordingly, before it could impose a tax on interest earned on all municipal bonds, California would need to amend its Constitution. On the other hand, if a State chooses to exempt all municipal bond interest from taxation, the State may face tens of thousands of claims for refunds, based on taxes collected on interest income under what would have been determined to be an unconstitutional statute.

Another possible consequence that States will have to prepare for is the effect on demand for their municipal bonds. In financial markets, uncertainty typically causes investors to exit the market, and fewer investors may lead to higher issuance costs. A State that relies on municipal bonds as a major source of financing will need to anticipate whether the proposed change – either imposing a tax on its own municipal bonds or exempting all municipal bonds from tax – will increase or decrease demand for the bonds it issues. For instance, if a State chooses to exempt all municipal bonds from tax, that State's bonds may lose some of their appeal, relative to extraterritorial bonds, and extraterritorial bonds may become relatively more attractive. Conversely, if a State discontinues the exemption for interest on in-State municipal bonds, one would expect the reduced incentives to lead to a reduced pool of investors for those bonds and, consequently, the need to pay higher interest rates. Although demand from

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[10] Cal. Const. art. XIII, § 26.

State residents and non-residents eventually may reach an equilibrium, no one could possibly predict when that would happen, and States meanwhile would be forced to speculate about the revenue to be generated by their municipal bonds when planning their budgets.

Even if demand for a State's bonds remained constant, the effect on budgets from State to State would be unpredictable because the revenue generated by the bonds would depend largely upon the State's marginal tax rate. States with high marginal tax rates that opt to exempt interest on all municipal bonds likely would suffer a larger decrease in revenue than States with low marginal tax rates that, likewise, opt to exempt interest on all municipal bonds. For example, one group of commentators estimates that the revenue lost by New York State, if it opted to exempt interest on all municipal bonds, would be $45.8 million, while Oregon would lose as little as $8.5 million if it did the same.[11] Conversely, States with high marginal tax rates that choose to tax interest on all municipal bonds likely will experience a larger boost to revenue than States with lower marginal tax rates.

Impact on Investors

For the bondholders, these changes could mean many things. Under the current system in most States, investors have a tax incentive to buy municipal bonds issued by the State in which they live and are thereby encouraged to invest in capital improvement projects within their own States. If that incentive evaporates – because the States would be required to treat all municipal bonds equally – investors may forgo municipal bonds and seek, instead, higher-yielding corporate bonds. Investors who continue to trade in the

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[11] *See* Dwight Denison, Merl Hackbart, & Michael Moody, Inst. for Federalism & Intergovernmental Relations, Working Paper No. 2007-03, *Davis* v. *Department of Revenue of Kentucky: A Preliminary Impact Assessment* 14 (Oct. 20, 2006).

municipal bond market would face the consequences of the uncertainty caused by disruption of the status quo.

In addition to encountering volatility in the market, investors likely would face the potential for litigation with the dealers and/or the issuing municipalities. If the Court strikes down the existing Kentucky tax treatment of municipal bonds, the ruling necessarily would have retroactive application. See *Harper* v. *Virginia Dep't of Taxation*, 509 U.S. 86, 90 (1993) (requiring that courts give retroactive effect to rulings applied by the Court to the parties before it). As discussed above, to comply with the ruling, the States would be required to treat interest on all municipal bonds equally, regardless of the bonds' issuer. If a State opts to exempt interest on all municipal bonds, potentially huge classes of investors who paid taxes on extraterritorial bonds under the abolished tax schemes will seek refunds for those payments. Attempts to recover improperly collected taxes may require significant cost and effort by the investors, and may embroil the issuers and/or the dealers in extensive litigation.

This possible consequence is not necessarily avoided if States opt to abolish the exemption altogether because, in that case, investors potentially face attempts by States to recover the previously forgone tax revenues, and the bondholders would be prospectively subject to taxes that did not exist when they purchased the bonds. Investors no doubt would argue that when the State opted to tax previously tax-exempt municipal bonds, the State became liable for a breach of its obligations.[12] See *United States* v. *Winstar Corp.*, 518 U.S.

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[12] Currently, Minnesota is the only State with a preferential tax scheme similar to the Kentucky statute at issue that has provided for the contingency that a court may find its tax scheme unconstitutional. In 1995, Minnesota enacted legislation providing for taxation of all bonds, including its own otherwise tax-exempt bonds, in the event that its disparate tax treatment of municipal bonds is struck down. *See* Minn. Stat. § 289A.50(10). This provision may supply Minnesota municipal-

839 (1996) (plurality opinion). If the Winstar litigation and avalanche of related claims is any indication, suits over taxes assessed on previously tax-exempt bonds could consume the States and their budgets, as well as investors, in litigation for years to come. See, *e.g.*, Marcia Coyle, *Broken Promises May Bust Budget: S&L's High Court Victory in* 'Winstar' *Is Cited by Others to Demand Billions*, Nat'l L.J., Apr. 27, 1998, at A1.

Impact on the Market

As it currently stands, the municipal bond market is extremely efficient and provides excellent access to small issuers. If the status quo is disturbed, there are numerous possible consequences for the marketplace. Uncertainty has adverse effects on market prices and is thus disadvantageous to the municipal bond markets.

While market participants learn to navigate these new waters, the market may experience a period of what can be considered "price discovery." Issuers as well as broker-dealers may be unsure of the demand for all-taxable or all-exempt municipal bonds. As in any new market, they may be forced to determine how to value the bonds through trial and error. This price discovery period would last for an unknown period of time, during which issuers and broker-dealers would be forced to make quick price adjustments in response to demand. As a result, until a reasonable price is established, many investors may under- or overpay for municipal bonds, and States, in turn, may be shortchanged. Moreover, in light of the possible turmoil in the market, market makers may face a barrage of requests for bids on currently-held municipal bonds, but with all the uncertainty about how States are going to react, they would lack sufficient information to make a

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ities with a defense from some claims that they breached their obligations to investors because the post-legislation investors presumably were on notice of the possible tax consequences, but that does not mean that Minnesota municipalities would avoid litigation altogether.

reasonable bid. Market makers may be forced to buy back municipal bonds but may be unable to find a market for the bonds for quite some time, causing inventory to swell to unusual levels.

The valuation process of municipal bonds is already a complicated one, taking into consideration things like their typically low default rate, taxable rate (if any), and other factors specific to the issuing municipality. Requiring States to alter their tax treatment of municipal bonds by striking down the Kentucky statute would further complicate this process. It certainly would mean that market participants – the investors, the State, and/or the broker-dealers – will be hurt along the way, until the full effect of the States' reactions to a finding that the Kentucky statute is unconstitutional could be absorbed by the market.

CONCLUSION

For the foregoing reasons, SIFMA respectfully requests that the Court reverse the decision of the Kentucky Court of Appeals.

Respectfully submitted.

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No. 06-666

IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF KENTUCKY, ET AL.,

Petitioners,

v.

GEORGE W. DAVIS, ET UX.,

Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF OF THE TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

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No. 06-666

IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF KENTUCKY, ET AL.,

Petitioners,

v.

GEORGE W. DAVIS, ET UX.,

Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF OF THE TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

INTEREST OF THE *AMICUS CURIAE*

The Tax Foundation submits this brief as *amicus curiae* in support of Respondents in the above-captioned matter.[1]

The Tax Foundation is a non-profit research

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioners and Respondents have been obtained and filed with the Clerk of the Court.

organization founded in 1937 to educate taxpayers about sound tax policy. To this end, we disseminate information on taxes and promote tax systems that are simple, fair, and conducive to economic growth. The Tax Foundation works to further this mission by educating the legal community on issues relating to tax law, by explaining tax law concepts to lawmakers and the public in an understandable and relevant manner, and by advocating that judicial decisions on tax law promote principled tax policy. Accordingly, the Tax Foundation has a direct stake in the outcome of this case.

SUMMARY OF ARGUMENT

The Commerce Clause prohibits state laws like Kentucky's that effectively tax activity out-of-state while exempting identical activity occurring in-state. This Court has recognized, however, that this does not prohibit every state law that may affect economic decision-making, because permitting states to design tax systems that foster a competitive business climate goes hand in hand with the federalism and liberty that the Commerce Clause protects. By clarifying that "tax neutrality" means "competitive neutrality," this Court will reach the proper result here and remain consistent with its precedents.

This case also provides an opportunity for this Court to consider the domestic application of the Import-Export Clause of Article I, Section 10, which would prevent states from penalizing activity that crosses state lines. Further, this case could implicate the Privileges or Immunities Clause of the Fourteenth Amendment, which protects the right of citizens to cross state lines in pursuit of an honest living.

A ruling for Respondents in this case would not unduly infringe Kentucky's sovereignty, as states could still permit exclusion of all municipal bond interest from taxable income, as is done at the federal level and in

Indiana. Nor would a ruling for Respondents excessively impact the municipal bond market, as states would still have access to capital at competitive interest rates.

Finally, this Court should be cautious about suggesting that discriminatory taxes should receive greater constitutional scrutiny than discriminatory subsidies. A state subsidy program with identical economic effects as Kentucky's tax should undergo identical constitutional scrutiny; otherwise, states could continue discriminatory schemes in a different but equally harmful form.

ARGUMENT

I. THE COMMERCE CLAUSE EMBRACES THE PRINCIPLE OF COMPETITIVE NEUTRALITY, WHICH PROHIBITS STATES FROM TAXING ACTIVITY OUT-OF-STATE WHILE NOT TAXING IDENTICAL ACTIVITY IN-STATE.

By clarifying that "tax neutrality" means "competitive neutrality," and that states cannot tax activity out-of-state if identical activity in-state is left untaxed, this Court can reach the proper result in this case, remain consistent with its precedents, and chart a course that lessens the tension between discriminatory taxation and permissible state tax experimentation. Competitive neutrality means that this Court can uphold state tax "welcome mats" that foster new investment in labor and capital within a state, while retaining the power to invalidate state tax "exit tolls" that seek to protect a state's existing industry from interstate competition.

Kentucky's exclusion is just such an "exit toll." Since 1913, federal tax law has allowed taxpayers to exclude from gross income the interest generated by state and

local municipal bonds. *See* 26 U.S.C. § 103.[2] Kentucky tax filers are instructed to start with federal gross income, then to add back in any municipal bond income earned from "other states and their political subdivisions." KY. REV. STAT. § 141.010 *et seq.* Kentucky is among 42 of the 43 income-taxing states that exclude interest from in-state municipal bonds but tax interest from out-of-state bonds. *See* Ethan Yale & Brian D. Galle, *Municipal Bonds and the Dormant Commerce Clause After* United Haulers, 44 STATE TAX NOTES 877, 878 (Jun. 18, 2007).

While this Court has consistently invalidated state statutes that discriminate against interstate commerce, those rulings have not resolved the tension between forbidden tax discrimination and permissible tax experimentation. On one hand, this Court has held that the Commerce Clause prohibits state laws like Kentucky's, which channel investment into the state by penalizing investments made out-of-state, thus "foreclos[ing] tax neutral decisions." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977). But this Court has recognized that not every state law that may affect economic decision-making is discriminatory, because permitting states to enact a lower tax rate, for instance, fosters a competitive business climate consistent with the federalism and liberty that the Commerce Clause protects. *See e.g.*, Clayton P. Gilette, *Business Incentives, Interstate Competition, and the Commerce Clause*, 82 MINN. L. REV. 447, 448 (1997) (arguing that state competition promotes the goals of the Commerce Clause). The Commerce Clause should be held to forbid a state from taxing an out-of-state activity if the state solely exempts identical in-state activity from taxation.

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[2] But gains realized from the sale of exempt bonds are taxed. Also, interest from private-activity municipal bonds is taxed federally under the Alternative Minimum Tax (AMT), which denies tax preferences to many high-income taxpayers. *See* 26 U.S.C. § 57(a)(5)(C).

A. The Commerce Clause, as interpreted by this Court's precedents, prohibits states from imposing a tax on activity out-of-state while leaving identical activity in-state untaxed.

The people of the United States adopted the Constitution in large part because their existing national government had no power to stop states from imposing trade barriers between each other, to the detriment of the national economy. "[States' power over commerce,] guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . ., destructive to the harmony of the States, and fatal to their commercial interests abroad. This was the immediate cause, that led to the forming of a convention." *Gibbons v. Ogden*, 22 U.S. 1, 224 (1824) (Johnson, J., concurring). Consequently, among the powers granted to Congress by the new Constitution was that "[t]o regulate Commerce . . . among the several States," a provision known as the Commerce Clause. U.S. CONST. art. I, § 8, cl. 3. Congress and the courts thus have the power to strike down laws that discriminate against interstate commerce.[3]

Nevertheless, states still have incentives to impede interstate commerce, as they always will. *See, e.g.*, *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 193 (1994) ("[A tariff] violates the principle of the unitary national market by handicapping out-of-state competitors, thus artificially encouraging in-state production even when the same goods could be produced at lower cost in other States."); *Dean Milk Co. v. Madison*, 340 U.S. 349, 354 (1951) ("In thus erecting an economic barrier protecting a major local industry against competition from without the State, Madison plainly discriminates against interstate

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[3] The power of federal courts to act when Congress is silent was inferred from the Commerce Clause (the "dormant" or "negative" Commerce Clause). *See e.g.*, *Willson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829).

commerce."). When examining a statute under the Commerce Clause, this Court has looked for evidence that the state is foreclosing competitive neutrality—penalizing activity out-of-state while solely and effectively leaving identical activity in-state untaxed. Where a state is discriminating in this manner, the Court has invalidated the tax.

For instance, in *Boston Stock Exchange*, 429 U.S. at 318, New York had imposed a tax on stock transfers that used out-of-state brokers instead of in-state brokers. If a taxpayer switched from in-state to out-of-state brokers, New York would levy a higher tax. While this effective tax on activity out-of-state was correctly held to violate the Commerce Clause, this Court was careful to note that "(o)ur decision today does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry. . . . We hold only that in the process of competition no State may discriminatorily tax the products manufactured or the business operations performed in any other State." *Id.* at 336-37. The Court's ruling was concerned not with imposing uniformity, but rather with preventing the state from solely taxing activity out-of-state while leaving identical activity in-state untaxed.

In *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984), this Court described taxes invalidated in *Boston Stock Exchange* and *Maryland v. Louisiana*, 451 U.S. 725 (1981), as having impermissibly "impos[ed] greater burdens on economic activities taking place outside the State than were placed on similar activities within the State." *Id.* at 404. In *Westinghouse*, New York imposed a franchise tax but then gave a credit for in-state, but not out-of-state, activity. *See id.* at 390-94. The Court ruled that because the credit solely exempted activity in-state from a tax levied on activity both in-state and out-of-state, it was no different from a discriminatory tax. "Nor is it relevant that New York discriminates against business

carried on outside the State by disallowing a tax credit rather than by imposing a higher tax. The discriminatory economic effect of these two measures would be identical." *Id.* at 404. The Court was persuaded not only by the fact that New York had exempted activity in-state, but also that it had simultaneously imposed a tax on identical income earned out-of-state.

In *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), Hawaii imposed a 20 percent tax on wholesale liquor sales but exempted local producers. The Court framed the exemption in terms of "burden," rejecting the state's claim that the tax merely benefited in-state production without burdening production for out-of-state markets. "Virtually every discriminatory statute allocates benefits or burdens unequally; each can be viewed as conferring a benefit on one party and a detriment on the other. . . . Consequently, it is irrelevant to the Commerce Clause inquiry that the motivation of the legislature was the desire to aid the makers of the locally produced beverage rather than harm out-of-state producers." *Id.* at 273. The issue in *Bacchus Imports* was that Hawaii had applied a tax on activity both in-state and out-of-state, but solely exempted activity in-state. This resulted in an impermissible effective tax on activity out-of-state, because identical activity in-state was left untaxed.

The Court applied this same rule in four other cases where states applied a tax to activity in-state and out-of-state, but effectively left activity in-state exempted:

- Pennsylvania could not impose fees on all trucks while reducing other taxes for trucks in-state only. *See Am. Trucking Ass'n v. Scheiner*, 483 U.S. 266, 286 (1987) ("[A] state tax that favors in-state business over out-of-state business for no other reason than the location of its business is prohibited by the Commerce Clause.").
- Ohio could not grant a tax credit to all ethanol producers, but disallow it for non-Ohio producers. *See*

New Energy Co. v. Limbach, 486 U.S. 269, 273 (1988) ("This 'negative' aspect of the Commerce Clause prohibits economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.").

- Massachusetts could not impose a general dairy tax and distribute the revenues to domestic producers only. *See West Lynn Creamery*, 512 U.S. at 199 ("The pricing order in this case, however, is funded principally from taxes on the sale of milk produced in other States. . . . The pricing order thus violates the cardinal principle that a State may not 'benefit in-state economic interests by burdening out-of-state competitors.'").
- Maine could not provide a general charitable deduction to all taxpayers, but disallow it only for organizations that primarily serve non-Maine residents. *See Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 581 (1997) ("A State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State.").

The concept of competitive neutrality is also clearly seen in two other areas of Commerce Clause law not directly at issue in this case: the constitutionality of compensating use taxes and the physical presence rule in business taxation.

This Court upheld the constitutionality of compensating use taxes in *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937). There, Washington state had imposed a tax on the use of certain personal property in-state, except where the property had been subject to the state's sales tax. *See id.* at 580-81. The purpose was to ensure that all property in-state was subject to tax, regardless of origin. The Court upheld the tax because it was compensating and did not discriminate against interstate commerce. *See id.* at 583-84 ("Equality is the

theme that runs through all the sections of the statute. There shall be a tax upon the use, but subject to an offset if another use or sales tax has been paid for the same thing."). Use taxes are thus constitutional even though they tax activity out-of-state, because they do not exempt identical activity in-state from tax. If a state were to impose a higher use tax than sales tax, the state would be effectively penalizing activity out-of-state in violation of the Commerce Clause, as one court recently held. *See Molloy v. Gov't of the Virgin Islands*, No. 2006-51 (D.V.I. Jul. 25, 2007) (holding that a use tax imposed without a sales tax violates the Commerce Clause).

In *Quill v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed under the Commerce Clause its rule that a state cannot impose a sales tax collection obligation on a business unless that business is physically present in the state. "Undue burdens on interstate commerce may be avoided . . . by the demarcation of a discrete realm of commercial activity that is free from interstate taxation. [The physical presence rule] create[s] a safe harbor for vendors whose only connection with customers in the taxing State is by common carrier or the United States mail." *Id.* at 314-15. While North Dakota in that case had argued that borders are irrelevant in our modern economy, this Court recognized that subjecting non-present businesses to state taxation often means that activity out-of-state is being unconstitutionally taxed.

Many states seek to export their tax burdens and impose taxes on businesses not physically present in the state, which by definition are taxes on activity occurring out-of-state. *See, e.g., Tax Comm'r of the State of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 236 (W.V. 2006), *cert denied*, No. 06-1228 (Jun. 18, 2007) (upholding state income taxation of out-of-state business). This Court understood in *Quill* that limiting states to taxing only businesses that are physically present is a way to ensure that states are not burdening activity out-

of-state more than activity in-state.

In this case, this Court has the opportunity to clarify that the Commerce Clause embraces the principles of competitive neutrality as outlined here and in the precedents. States cannot impose a tax on activity both in-state and out-of-state, and effectively exempt solely activity in-state, or impose a penalty on activity out-of-state while not penalizing identical activity in-state. This Court has consistently invalidated such laws under the Commerce Clause, and should do so again here.

B. Kentucky's law imposes a tax on activity out-of-state, while leaving identical activity in-state untaxed.

Kentucky residents who file the individual income tax form are instructed to start with their federal calculation of gross income, which excludes all municipal bond interest. *See* KY. REV. STAT. § 141.020(8)(a). Kentucky then requires that filers add in all interest income from non-Kentucky municipal bonds. *See* KY. REV. STAT. § 141.020(8)(a)(1). At no point are filers instructed to report, much less pay tax on, interest earned from Kentucky municipal bonds. The state therefore subjects individuals who have earned municipal bond interest outside of the state to reporting and payment obligations that are not imposed on those who have earned identical interest income in-state.

The law challenged here penalizes disfavored activity. Those who hold out-of-state municipal bonds are penalized because they engage in activity disfavored by a state practicing protectionism. The state tax code is designed to make investing in Kentucky bonds the only way such individuals can lower their effective tax rate on municipal bond income. The state has gone beyond differential treatment, which can be constitutional. Instead, it is penalizing activity simply because it crosses state lines.

C. This Court should recognize that Kentucky's law taxes activity occurring out-of-state, and thus differs from valid laws that do not.

The Commerce Clause cannot require absolute neutrality in state tax systems because to do so would destroy the states' sovereign tax powers. Permitting states to design tax systems that foster a competitive business climate is a feature of federalism that is protected by the Commerce Clause. Consequently, many state tax laws that affect economic decision-making or impose differential treatment are constitutionally permissible. For instance, states are free to reward certain activity in the form of exemptions or deductions from taxes without national uniformity. Also, different states can enact different tax rates, creating more favorable fiscal and economic climates, in which businesses might locate capital and labor.

If a state imposes a tax that applies both in-state and out-of-state, it cannot then solely exempt activity that occurs in-state from the tax. Similarly, a state may not effectively tax activity out-of-state while leaving activity in-state untaxed. Because Kentucky taxes the worldwide income of its residents, *see* KY. REV. STAT. § 141.010 *et seq.*, it cannot solely exclude income earned within the state from tax. Additionally, Kentucky cannot tax out-of-state bond investments while leaving in-state bond investments untaxed.

In *DaimlerChrysler Corp. v. Cuno*, 547 U.S. ___; 126 S. Ct. 1854 (2006), this Court faced[4] the question of whether a state's investment tax credit, conditioned on the location of new capital within the state, violated the Commerce

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[4] The Supreme Court ultimately dismissed the case for lack of standing, holding that the plaintiffs had not demonstrated any injury (i.e., the state had imposed no penalty on them). *See Cuno*, 547 U.S. at ___, 126 S.Ct. at 1854.

Clause. The lower court had held Ohio's investment tax credit to be unconstitutional because it was not "tax neutral." "[T]he economic effect of the Ohio investment tax credit is to encourage further investment in-state at the expense of development in other states and that the result is to hinder free trade among the states." *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738, 745 (6th Cir. 2004). Under this reasoning, any state tax law that differed from tax laws in other states would be constitutionally suspect. The case was also unusual because unlike many Commerce Clause cases, it did not involve an out-of-state taxpayer seeking to use the Clause to invalidate a protectionist law, but rather in-state taxpayers seeking to use the Clause to protect their state from interstate tax competition.

In the Tax Foundation's *amicus curiae* brief supporting a writ of certiorari, we argued that the Sixth Circuit's conception of "tax neutrality" under the Commerce Clause was restrictive, not protective, of interstate commerce. "[I]f taken literally, [it] mean[s] that a state cannot develop a tax policy that encourages growth and investment. Not even tax rate reductions or exemptions would be allowed under this literal language." Brief of Tax Foundation as Amicus Curiae Supporting Petition for Writ of Certiorari, *Daimler Chrysler Corp. v. Cuno*, (2005) (No. 04-1704), at 12. The reason is that virtually any tax change has some economic effect that may encourage or discourage behavior. Instead, we explained there, as we have explained here, that a better standard is "competitive neutrality"—forbidding laws that impose tariff-like punishment on out-of-state activity to protect native industry, but authorizing laws that seek to encourage the formation and deployment of new labor and capital. *See also* Phillip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 VAND. L. REV. 879 (1986). The key question for determining

impermissible discrimination is whether a state is taxing or otherwise penalizing activity occurring out-of-state. Here, the municipal bond exclusion punishes out-of-state activity to protect in-state activity.

The investment tax credit at issue in *Cuno* was constitutional because it was competitively neutral—Ohio did not tax business income earned outside the state, nor did it exempt activity in-state from taxation while taxing activity out-of-state. *See* Brief of Council on State Taxation and National Association of Manufacturers as Amicus Curiae In Support of Petition for Writ of Certiorari, *DaimlerChrysler Corp. v. Cuno* (2005) (No. 04-1704), at 9 ("[T]he calculation of the Ohio investment credit includes no refererce to out-of-state activity, which is neither incented or disincented."). Contrast that to the present case, where the effect of Kentucky's exemption is to tax only the income generated by investment in out-of-state municipal bonds. The Ohio investment tax credit was a "welcome mat," available on a neutral basis to any company from any state that invested capital in Ohio, while the Kentucky exclusion is an "exit toll," penalizing taxpayers who choose to do business in other states.

The Respondents in this case have suffered injury—they have had to suffer a penalty for engaging in activity out-of-state, while those who engaged in identical activity solely in-state have been exempted. Only those who have earned interest income out-of-state are required by Kentucky to report the amount and pay tax. The state seeks to influence economic behavior by imposing a penalty on those who invest in municipal bonds out-of-state.

Kentucky's law is also different from laws upheld by this Court that discriminate against interstate commerce, but do so only where the state is acting like any other market participant. *See, e.g., Reeves, Inc. v. Stake*, 447 U.S. 429 (1980) (holding that a state in the business of

selling cement to buyers may discriminate against out-of-state buyers); *Am. Yearbook Co. v. Sakew*, 409 U.S. 904 (1973) (holding same for printing services). In taxing interest income, Kentucky is not acting as a market participant, but as a sovereign state exercising the power of mandatory taxation. *Cf. New Energy Co.*, 486 U.S. at 277 ("[A]ssessment and computation of taxes [is] a primeval governmental activity."). Even if it could be said that Kentucky is "competing" with the private bond market, the relevant action in this case is its use of the taxing power, which is an exercise of governmental authority that no other market participant could exercise.

Some *amici* may point to this Court's recent decision in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 550 U.S. ___ (slip op. Apr. 30, 2007) (No. 05-1345), which held that a state may require waste haulers to use a state-run processing operation. *See id.* But there, the state law made no reference to activity out-of-state. The state did not effectively penalize out-of-state activity by leaving identical in-state activity unpenalized, nor was solely in-state activity exempted from burdens otherwise imposed. Non-governmental activity was barred regardless of where it occurred. Here, in contrast, Kentucky penalizes only some private investors—those who invest in bonds out-of-state. The Commerce Clause forbids the use of effective penalties on activity out-of-state while leaving identical activity in-state unpenalized, not the legal protection of a government-run enterprise from all private competitors. "[W]hile *United Haulers* lifts the presumption of unconstitutionality from laws favoring state-run businesses in competition with private business, it is doubtful that the Court would turn such a favorable eye on laws shielding state officials from the pressure of competition with rival state-run enterprises." Yale & Galle, *supra*, at 895.

Federalism guarantees that states retain autonomy over their tax systems so long as they do not enact protectionist measures that punish only out-of-state activity. This policy encourages competition conducive to economic growth. The Commerce Clause protects this competitive neutrality and does not prohibit states from bestowing benefits on a favored activity while leaving all other actors as they were. There is no injury in such a case, and to hold otherwise would essentially force states to subsidize out-of-state activity.

But where a state imposes a tax on activity out-of-state, while leaving identical activity in-state untaxed, the state is discriminating against interstate commerce and has run afoul of the Commerce Clause. Kentucky has done so here, and its punitive tax treatment of out-of-state bond interest should be invalidated.

II. THIS COURT SHOULD CONSIDER WHETHER THE KENTUCKY EXCLUSION VIOLATES THE IMPORT-EXPORT CLAUSE AND THE PRIVILEGES OR IMMUNITIES CLAUSE.

This Court might consider two other provisions of the Constitution that provide additional textual and historical support for the concept of competitive neutrality. This case provides an opportunity for this Court to hold that the Import-Export Clause of Article I, Section 10 applies domestically and prevents states from penalizing economic activity because it crosses state lines. This Court could also hold that Kentucky's taxation of out-of-state municipal bond interest violates the Privileges or Immunities Clause of the Fourteenth Amendment, which protects the right of citizens to engage in interstate transactions.

A. The Import-Export Clause of Article I, Section 10 prohibits states from penalizing activity that crosses state lines.

Article I, Section 10 of the Constitution states that "[n]o State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection laws. . . ." U.S. CONST. art I, § 10, cl. 2. The rationale for the Import-Export Clause was the same as the Commerce Clause: to stop states from endangering the national economy by imposing trade barriers. "[T]here is . . . wisdom and policy in restraining the states themselves from the exercise of the same power [taxation] injuriously to the interests of each other. A petty warfare of regulation is thus prevented, which would rouse resentments, and create dissensions, to the ruin of the harmony and amity of the states." 1 STORY CONST. § 497 (discussing the Import-Export Clause).

The Import-Export Clause was thus conceived as barring states from imposing taxes on activity that crossed state lines. *See, e.g.*, Brannon P. Denning, "The Import-Export Clause" *in* THE HERITAGE GUIDE TO THE CONSTITUTION 176, 176-77 (David F. Forte ed., 2005) ("Evidence from the Constitutional Convention and the ratification debates suggest that the Framers intended the Import-Export Clause to complement congressional power to raise revenue and regulate interstate commerce by restricting the states' ability to tax commerce entering and leaving their borders."). Applied, the Import-Export Clause would provide a more focused and textual basis for the invalidation of any state tax "that is levied exclusively, or even primarily, on imports." *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 640 n.22 (Thomas, J., dissenting). Here, Respondents are importing municipal bond income from other states, and Kentucky is taxing that import.

The original meaning of the Import-Export Clause included domestic application, although the Supreme Court held otherwise in *Woodruff v. Parham*, 75 U.S. 123

(1868), when it stated that the restriction applied only to goods originating outside the United States. In doing so, the Court distinguished two prior cases that suggested the Clause applied domestically. *See Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 449 (1827); *Almy v. California*, 65 U.S. 169, 172-74 (1861). The basis for the *Woodruff* Court's conclusion was a lack of evidence to deny that the word "imports" was meant to be an "exclusive reference to foreign trade." *Id.* at 136. Subsequent research has undermined this ground, with scholars uncovering examples of the Founders and contemporaneous ratifying conventions, newspapers, laws, and writers using the word "imports" to describe interstate trade.[5] "The evidence suggests that the *Woodruff* Court was too hasty in its dismissal of Marshall's dictum in *Brown*, and wrong to recharacterize *Almy v. California*, because Justice Miller's reading of the Import-Export Clause was too narrow." Denning, *supra*, at 213. "Commerce" as used in the Constitution comprises both foreign and interstate commerce; a consistent reading of "imports and exports" would include foreign and interstate trade as well.

Kentucky's tax on municipal bond interest that crosses state lines, or the activity that generates such interest, is an impermissible duty on imports even if it is the activity that is taxed and not the goods. *Cf. Camps Newfound/Owatanna*, 520 U.S. at 574-75 (stating that a tax on activities used in relation to imported goods is the legal and functional equivalent to a tax on the imported goods). Not all interstate taxation is impermissible. This Court has held that "the Import-Export Clause prohibited only exactions on the right of importation," *Michelin Corp. v. Wages*, 423 U.S. 276, 295 (1976), that "create special protective tariffs *or particular preferences* for certain

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[5] *See generally Camps Newfound/Owatanna*, 520 U.S. at 621-33 (Thomas, J., dissenting) (detailing these examples); Denning, *supra*, at 188-215 (same).

domestic goods . . . ." *Id.* at 286 (emphasis added). "[T]he prohibition would not apply to a state tax that treated imported goods . . . in a manner that did not depend on the foreign origins of the goods." *Id.* at 298. A general tax on all municipal bond income would not violate the Clause. But here, a duty is imposed on all municipal bond interest not generated in Kentucky, and that duty is designed to discourage interstate activity and encourage domestic investment.

This case is an example of what the Import-Export Clause was designed to prevent: a state imposing a penalty on economic activity that crosses state lines. Rising at the Constitutional Convention to voice a concern that led to the Clause's adoption, Gouverneur Morris warned that states would try to tax each other to the detriment of national unity. "These local concerns ought not to impede the general interest. There is great weight in the argument, that the exporting States will tax the produce of their uncommercial neighbors." SUPPLEMENT TO MAX FARRAND'S THE RECORDS OF THE FEDERAL CONVENTION OF 1787, at 360 (James H. Hutson ed., 1987). Kentucky imposes a penalty on activity that crosses state lines. This Court should reconsider *Woodruff* and hold that Kentucky's law runs afoul of the Import-Export Clause.

B. The Privileges or Immunities Clause of the Fourteenth Amendment protects the right of citizens to cross state lines in pursuit of an honest living.

The Fourteenth Amendment, enacted after the Civil War, reads in part:

> "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States. . . ."

U.S. CONST., amend. XIV, § 1. The U.S. Constitution also

requires that the privileges and immunities enjoyed by citizens of a state must also be extended to other U.S. citizens in that same state. *See* U.S. CONST., art. IV, § 2. *See also* ARTICLES OF CONFEDERATION art. IV ("The better to secure and perpetuate mutual friendship and intercourse among the people of the different States in this Union, the free inhabitants of each of these States . . . shall be entitled to all privileges and immunities of free citizens in the several States. . . ."). Not until Reconstruction, however, was it considered necessary to adopt a constitutional amendment to protect citizens' basic civil rights from infringement by state governments.

Chief among these was the right to earn an honest living, which many states systematically violated in order to keep African-Americans in constructive bondage following the Civil War. In the *Slaughterhouse Cases*, 83 U.S. (16 Wall.) 36 (1873), the Supreme Court adopted a narrow view of the scope of rights guaranteed by the Clause, over four dissents. This decision has been harshly and consistently criticized by a distinguished assortment of judges and scholars. *See, e.g.*, RANDY BARNETT, RESTORING THE LOST CONSTITUTION 195-203 (2004); Laurence H. Tribe, *Taking Text and Structure Seriously: Reflections on Free-Form Method in Constitutional Interpretation*, 108 HARV. L. REV. 1221, 1297 n.247 (1995); Akhil R. Amar, *The Bill of Rights and the Fourteenth Amendment*, 101 YALE L.J. 1193, 1258-59 (1992); JOHN HART ELY, DEMOCRACY AND DISTRUST 22 (1980). *But see* ROBERT BORK, THE TEMPTING OF AMERICA: THE POLITICAL SEDUCTION OF THE LAW at 10 (1990) (describing the Clause as "a constitutional provision whose meaning is largely unknown.").

Even after the *Slaughterhouse Cases*, this Court has identified "pursuit of a common calling" as a privilege of national citizenship protected by the Constitution. *See United Bldg. & Constr. Trades v. Mayor*, 465 U.S. 208,

219 (1984). *See also* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW 450 (2d ed. 2002) ("The vast majority of cases under the [Article IV] privileges and immunities clause involve states discriminating against out-of-staters with regard to their ability to earn a livelihood.").

This Court has also consistently held that the Privileges or Immunities Clause protects the right to cross state lines without interference. Most recently, in *Saenz v. Roe*, 526 U.S. 489 (1999), this Court applied the Clause to strike down a California welfare benefits law that applied differently to California residents based on their prior interstate travel. *See Saenz*, 526 U.S. at 504 ("Because this case involves discrimination against citizens who have completed their interstate travel, the State's argument that its welfare scheme affects the right to travel only 'incidentally' is beside the point."). The Court specifically grounded the right to interstate travel in part in the Privileges or Immunities Clause, noting that while the law did not restrict travel *per se*, it discouraged the crossing of state lines with a punitive and discriminatory law. "It was the right to go from one place to another, including the right to cross state borders while en route, that was vindicated in *Edwards v. California*, 314 U. S. 160 (1941), which invalidated a state law that impeded the free interstate passage of the indigent." *Saenz*, 526 U.S. at 500. *See also id.* at 511 (REHNQUIST, C.J., dissenting) ("The right to travel clearly embraces the right to go from one place to another, and prohibits States from impeding the free passage of citizens.").

The Court has thus invalidated laws that discourage individuals from crossing state lines and enjoying the benefits of national citizenship, such as pursuit of an honest living. In *Colgate v. Harvey*, 296 U.S. 404 (1935), *overruled by Madden v. Kentucky*, 309 U.S. 83, 90-93 (1940), Justice Sutherland wrote for the Court: "[W]hen

[a citizen] trades, buys, or sells, contracts or negotiates across the state line . . ., he exercises rights of national citizenship. . . ." *Id.* at 433. In *Madden*, which overruled *Colgate*'s broader reading of the Privileges or Immunities Clause, the Court nevertheless stated that the Clause protects "privileges and immunities arising out of the nature and essential character of the national government, and granted or secured by the constitution of the United States." *Madden*, 309 U.S. at 92 n.21. The Privileges or Immunities Clause protects the right of "all citizens to be free to travel throughout the length and breadth of our land uninhibited by statutes, rules, or regulations which unreasonably burden or restrict this movement." *Saenz*, 526 U.S. at 499, *quoting Shapiro v. Thompson*, 394 U.S. 618, 629 (1969). States can neither penalize the crossing of state lines nor impose burdens on those who exercise that right, such as with the California law invalidated in *Saenz*.

Here, Kentucky penalizes those who pursue a calling and engage in honest commercial activity that crosses state lines, while not imposing similar burdens on those whose activity does not cross state lines. As Justice Cardozo wrote, "The Constitution was framed . . . upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 523 (1935). Because this Court has held that pursuit of a common calling is such a privilege of national citizenship, and that states cannot enact laws that discourage the crossing of state lines, a law such as Kentucky's must be invalidated, for it discourages Respondents from commercially crossing state lines in pursuit of an honest living. This Court should consider re-evaluating the *Slaughterhouse Cases* and protect the rights of Respondents in a way that would be faithful to history and text.

III. A RULING FOR RESPONDENTS WOULD NEITHER UNDULY INFRINGE KENTUCKY'S STATE SOVEREIGNTY NOR EXCESSIVELY IMPACT MUNICIPAL BOND MARKETS.

A ruling for Respondents in this case would not infringe Kentucky's state sovereignty, as states could still permit exclusion of all municipal bond interest, as is done at the federal level and in Indiana, or tax all municipal bond interest. Nor would a ruling for Respondents excessively impact the municipal bond market, as state and local governments would still have access to capital at competitive interest rates.

A. A ruling for Respondents would not unduly infringe state sovereignty, as states could still allow a non-discriminatory municipal bond interest exclusion, or tax all municipal bond interest income.

This Court has been conscious that its rulings can have serious consequences, and that preserving a controversial rule is sometimes preferable to unleashing uncertainty and disrupting settled expectations. At least one *Amicus* urges this Court to reverse on this ground. *See* Brief of the Securities Industry & Financial Markets Association as Amicus Curiae Supporting Petitioners, *Kentucky v. Davis* (2007) (No. 06-666), at 5 ("If the municipal bond tax incentive evaporates, the demand for such bonds may likewise vanish, thus drying up a major source of funding for State projects."). But this case is not one of *fiat justitia ruat caelum*; a ruling for Respondents need not cause the sky to fall.

This Court should consider these concerns, but they neither dictate a result nor are they ultimately persuasive. The effect on settled expectations is just one consideration this Court has outlined for purposes of reversing lower courts and reconsidering previous

decisions. *See, e.g.*, *Patterson v. McLean Credit Union*, 491 U.S. 164, 173-74 (1989) (outlining said considerations).

Some of the *amici* erroneously assume that any ruling for Respondents would result in this Court barring states from exempting or excluding municipal bond interest. This is not so. Kentucky could exempt all municipal bond interest, or none; the decision would be left to the commonwealth. If Kentucky chooses to exempt all municipal bond interest income from taxation, the state law would no longer discriminate against interstate commerce. Neither constitutional amendments nor upheaval would be required. Because the state's action would not be preordained from the judicial result, and because the state would still be able to select from many policy choices, its sovereignty is not threatened. Kentucky would simply be following in the path of Indiana and the federal government, both of which exempt all municipal bond interest without distinction.

B. A ruling for Respondents would not excessively impact municipal bond markets.

The municipal bond market is admittedly large. But tax exclusions, exemptions, and deductions are matters of legislative grace. They can be increased, decreased, rewritten, or repealed with little or no notice. As recently as 1986, the U.S. federal income tax code was overhauled, with many expectations repealed or revised. Many states, including Michigan, Ohio, and Texas, have recently overhauled their tax codes as well. Markets that exist solely to take advantage of the tax code, such as "state-specific" bond mutual funds, can be channeled into more productive uses after such changes. "States raised money from the bond market long before there were state-specific funds." Brian D. Galle & Ethan Yale, *Can Discriminatory State Taxation of Municipal Bonds Be Justified? Thoughts on the* Davis *Topside Briefs*, TAX NOTES (forthcoming

2007), *available at* http://ssrn.com/abstract=1014138, at 8. Of course, it is preferable that such revisions be done legislatively rather than judicially. But this Court is not being asked to rewrite Kentucky's tax code; it is instead being asked to uphold the Constitution.

This Court will hear arguments that an adverse ruling for Kentucky would result in deprivation of the states' access to capital. This will not occur, for two reasons. First, even assuming that all bonds (municipal and private) must be treated identically for tax purposes, this would simply mean that municipal bonds would have to compete on credit risk, rate of return, and the merits of the project rather than on tax benefits. Kentucky could, for instance, increase the rate of interest paid to bondholders in order to attract more capital. Furthermore, the reliability of tax revenues to repay debt might make these investments more attractive than private bonds. Only states with unsalvageable credit would have no access to capital in today's markets, and that fact would not change with or without the tax exclusion at issue here.

Second, the federal tax code will still exclude income earned from municipal bond interest from gross income. This exclusion has existed since 1913, and is not at issue here, nor in a conceivably related case. Municipal bonds will still enjoy this federal tax advantage over private bonds, regardless of any state action, and because federal rates are greater than state rates, the federal exclusion is more valuable. Of course, if states opted to exclude all municipal bond interest, rather than just domestic bonds, municipal bonds would become more valuable than they are at present, and demand for them would rise, not fall.

A ruling for Respondents still leaves Kentucky and other similarly situated states with the autonomy to indepdently structure their tax systems, provided that they are in conformity with the requirements of the

Constitution. This Court has not resorted to reliance on expectations regarding laws that discriminate against interstate commerce to sustain an otherwise invalid law. Here, where a ruling for Respondents would still enable states to exclude municipal bond interest, such arguments should not discourage this Court.

C. Invalidating Kentucky's discriminatory taxation of out-of-state municipal bond interest income will affect some states more than others.

High-tax states use the municipal bond interest exclusion to shield their higher taxes from interstate competition. This is because the higher a state's tax rate is, the more the exclusion is worth to its taxpayers. This Court should consider this protectionist motivation when evaluating whether the Kentucky law discriminates against interstate commerce.

To understand why high-tax states benefit from the exclusion, first assume that the exclusion did not exist. If a $1,000 state or local government bond had to pay a 10 percent return annually, or $100, to attract enough bond buyers, every investor would benefit equally. *See generally* Patrick Fleenor, "Tax-Exempt State and Local Bonds: A $20 Billion Gift to the Nation's Wealthiest Investors," in *Fixing the Alternative Minimum Tax: AMT Reform Requires Changes to Regular Tax Code*, TAX FOUNDATION SPECIAL REPORT NO. 155 (May 2007), at 9, *available at* http://www.taxfoundation.org/files/sr155.pdf.

However, because of the exclusion, investors who pay higher taxes get a better interest rate. Again assuming a $1,000 bond paying 10 percent, investors in the highest federal tax bracket (say 35 percent) are willing to buy the bonds for interest payments of 6.5 percent since the $35 in tax savings brings their annual earnings from the bond to the desired 10 percent. The $35 gain to state and local

governments would equal the $35 in lost federal tax revenue. Investors in the 25 percent tax bracket would have to have a minimum interest rate of 7.5 percent, the point where the amount they save in taxes, $25 (25 percent of $100), brings their annual earnings from the bond to 10 percent.

Because state and local governments need to attract other investors, and not just those in the highest tax brackets, the highest rate necessary to clear the market must be given to all bond investors. So if a state offers a 7.5 percent interest rate to attract investors in the 25-percent tax bracket, bondholders in the 35-percent tax bracket get a better deal. They annually earn $110, instead of $100.

Consequently, the greater a state's income tax rate, the greater the benefit from the exclusion, and the interest rate the state must offer can be lower. States with the highest-tax individual income tax rates therefore have a stronger interest in preserving the municipal bond tax exclusion, because it enables them to protect those high tax rates from interstate competitive pressures. States with the lowest tax rates suffer because their comparative advantage in lower tax rates is eroded. This protectionist motivation for the exclusions is additional evidence that their purpose is, at least in part, to discriminate against interstate commerce.

IV. THIS COURT SHOULD BE CAUTIOUS NOT TO SUGGEST THAT DISCRIMINATION ANALYSIS APPLIES TO TAXES BUT NOT SUBSIDIES.

The current Kentucky law cannot accurately be described as a subsidy, and the constitutional scrutiny of discriminatory taxes is well-settled. But this Court should be cautious not to suggest that discriminatory taxes are more constitutionally suspect than discriminatory subsidies. The competitive neutrality

protected by the Commerce Clause prohibits states from imposing burdens on activity out-of-state and in-state while solely exempting activity in-state from those burdens. Similarly, a state cannot impose burdens on activity out-of-state while leaving unburdened identical activity in-state. Both subsidies and taxes that violate these principles should undergo identical constitutional scrutiny.

A. This Court has in the past rejected formalism in favor of economic reality, but has not extended that fully into the realm of discriminatory subsidies.

On numerous occasions, this Court has distinguished constitutional statutes from unconstitutional ones by looking at actual facts, rather than merely the words the statute uses or the form it takes. *See, e.g.*, *Complete Auto*, 430 U.S. 274, 288-89 (1977) ("There is no economic consequence that follows necessarily from the use of the particular words . . . and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect."); *Thomas v. Union Carbide Agric. Products*, 473 U.S. 563, 586 (1985) (*quoting Crowell v. Benson*, 285 U.S. 22, 53 (1932)) ("In deciding whether the Congress, in enacting the statute under review, has exceeded the limits of its authority . . ., regard must be had, as in other cases where constitutional limits are invoked, not to mere matters of form, but to the substance of what is required."); *New York v. United States*, 326 U.S. 572, 583 (1946) ("[W]e reject limitations upon the taxing power of Congress derived from such untenable criteria . . . ."); *United States v. Classic*, 313 U.S. 299, 313 (1941) (considering the practical operation of an election law that was formally open but restrictive in practice). Where a statute uses unconstitutional means or pursues unconstitutional ends, this Court should not cut short its inquiry just because the form is not unconstitutional.

Unfortunately, while this Court gives proper scrutiny to discriminatory taxes, comparable scrutiny is not given to discriminatory subsidies. Nineteen years ago, this Court wrote, "Direct subsidization of domestic industry does not ordinarily run afoul of [the Commerce Clause]; discriminatory taxation of out-of-state manufacturers does." *New Energy Co.*, 486 U.S. at 278. *See also West Lynn Creamery*, 512 U.S. at 199 ("We have never squarely confronted the constitutionality of subsidies, and we need not do so now. We have, however, noted that direct subsidization of domestic industry does not ordinarily run afoul of the negative Commerce Clause.").

These dicta contrast with statements by this Court suggesting that existence of discriminatory treatment merits constitutional scrutiny regardless of form. *E.g.*, *Westinghouse*, 466 U.S. at 404-05 ("Nor is it relevant that New York discriminates against business carried on outside the State by disallowing a tax credit rather than by imposing a higher tax. . . . We have declined to attach any constitutional significance to such formal distinctions that lack economic substance."); *Bacchus Imps.*, 468 U.S. at 273 ("The determination of constitutionality does not depend upon whether one focuses upon the benefited or the burdened party.").

The Court should take this opportunity to clarify that subsidies do not get a constitutional free ride. The question to ask regarding permissive and barred state action should not be whether it is in the form of a tax or a subsidy, but whether it imposes a penalty in a discriminatory way.

B. A state subsidy program with the identical economic effect of Kentucky's law here should be subject to the same discrimination analysis.

States should not be able to convert a discriminatory

tax into a discriminatory subsidy, and escape constitutional scrutiny. The Tax Foundation criticized the Sixth Circuit decision in *Cuno* for this reason. *See* Chris Atkins, *Federal Court Ruling May Hurt Tax Competition, State Tax Reform*, TAX FOUNDATION FISCAL FACT NO. 16 (2004) ("Making a distinction between subsidies and tax incentives seems highly formalistic. . . . Ohio can bypass the *Cuno* ruling by simply changing the tax incentive program into an investment subsidy."). The touchstone should not be the formal structure, but the economic effect.

The same danger is faced here. To avoid this result, courts should analyze a challenged subsidy for discrimination against interstate commerce no differently from an analysis of a challenged tax. Kentucky's statute challenged here effectively penalizes activity out-of-state by exempting solely identical activity occurring in-state. The competitive neutrality protected by the Commerce Clause prohibits states from imposing burdens on activity out-of-state and in-state while solely exempting activity in-state from those burdens, or imposing burdens on activity out-of-state while leaving unburdened identical activity in-state. Any law that does so should be held unconstitutional, be it tax or subsidy. This case presents an opportunity for this Court to reaffirm its statements in *Westinghouse* and *Bacchus Imports*, and value economic reality and presence of penalties over formalized categories.

CONCLUSION

Because the challenged statute penalizes those who engage in activity out-of-state by subjecting investment in out-of-state municipal bonds to tax burdens not borne by taxpayers investing in-state, this Court should hold the Kentucky exclusion unconstitutional. In doing so, this Court would not unduly infringe upon state sovereignty

nor excessively impact municipal bond markets.

This Court could also consider the Kentucky exclusion in light of the Import-Export Clause and the Privileges or Immunities Clause, because it imposes an impermissible duty on activity that crosses state lines and burdens individuals who cross state lines in pursuit of an honest living, in contravention of the rights those clauses are designed to protect. This Court should also be cautious not to suggest that discriminatory taxes are scrutinized more intensively than discriminatory subsidies.

For the foregoing reasons, *Amicus* respectfully requests that this Court affirm the decision below.

Respectfully submitted,

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September 21, 2007

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No. 06-666

IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,
Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

BRIEF OF ALAN D. VIARD, ALEX BRILL, CHRISTOPHER DEMUTH, JASON FURMAN, KEVIN A. HASSETT, R. GLENN HUBBARD, AND KENT SMETTERS AS *AMICI CURIAE* SUPPORTING RESPONDENTS

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QUESTION PRESENTED

Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.

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INTEREST OF *AMICI CURIAE* [1]

Amici are scholars of public policy ("the public policy *amici*") who wish to ensure that the Court is fully informed of the key economic issues relating to the Kentucky tax exemption challenged in this case,

[1] The parties have filed blanket consents to the filing of *amicus* briefs in this case. Pursuant to Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amici* or their counsel made a monetary contribution to the preparation or submission of this brief.

a selective exemption for interest income on municipal bonds issued by Kentucky and its political subdivisions that Kentucky does not grant to interest income on municipal bonds issued by other states. These *amici* believe that their extensive experience analyzing the economic effects of taxes and other public policies may assist the Court and that they bring a different perspective to the issue than the other parties. The public policy *amici* are filing this brief solely as individuals and not on behalf of any institution.

Alan D. Viard is a Resident Scholar at the American Enterprise Institute for Public Policy Research ("AEI"). He previously served as visiting scholar at the U.S. Treasury Department Office of Tax Policy, a senior economist at the President's Council of Economic Advisers, a senior economist at the Federal Reserve Bank of Dallas, an assistant professor of economics at Ohio State University, and an economist for the Joint Committee on Taxation of the U.S. Congress.

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Jason Furman is a Senior Fellow at the Brookings Institution and Director of the Hamilton Project. Furman is also an affiliate of the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution. He has written widely on tax policy and other economic policy issues. He has held a number of public service and teaching positions, including serving as a Staff Economist on the President's Council of Economic Advisers (1996–1997), Special Assistant to the President for Economic Policy, National Economic Council (1999–2000), Lecturer at Yale University (2001–2002), and Visiting Scholar at New York University's Wagner Graduate School of Public Service (2004–2007).

Kevin A. Hassett is Director of Economic Policy Studies and Senior Fellow at AEI and a weekly columnist for Bloomberg. He previously served as a senior economist at the Board of Governors of the Federal Reserve System and an associate professor at the Graduate School of Business of Columbia University. He also served as a policy consultant to the U.S. Department of the Treasury. Dr. Hassett is a member of the Joint Committee on Taxation's Blue Ribbon Dynamic Scoring Advisory Panel and its Estimating Review Panel. He is the author, coauthor or editor of six books on economics and economic policy and has published numerous scholarly papers in professional journals.

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STATEMENT OF THE CASE

The Commonwealth of Kentucky assesses income tax on the bond interest income earned by its residents, including interest earned on bonds issued by municipal governments. Like many other states, however, Kentucky exempts the income earned as interest on bonds issued by municipalities within Kentucky. *See* KEN. REV. STAT. ANN. §§ 141.010, 141.020 (2005). Kentucky offers no similar exemption for interest earned on bonds issued by municipalities outside of Kentucky. Similarly, it offers no tax exemption (nor could it) on the interest earned

on the bonds of Kentucky municipalities held by residents of other states.

Respondents filed suit in Jefferson Circuit Court in Jefferson County, Kentucky, alleging that the selective municipal bond tax exemption employed by Kentucky violated what is commonly referred to as the "dormant Commerce Clause" of the U.S. Constitution, because the selective tax exemption discriminates against interstate commerce. The Circuit Court granted Kentucky's motion for summary judgment and dismissed the case. In an opinion dated January 6, 2006, the Kentucky Court of Appeals reversed, holding that the exemption did violate the dormant Commerce Clause. *See Davis v. Kentucky*, 197 S.W.3d 557 (Ky. Ct. App. 2006). The Kentucky Supreme Court declined discretionary review on August 17, 2006, and this Court granted certiorari on May 21, 2007.

SUMMARY OF ARGUMENT

1. (a) This Court has held that state taxes may not discriminate against interstate commerce, relative to within-state commerce. Kentucky's selective municipal bond tax exemption discriminates against interstate commerce in municipal bonds, in both design and effect, because Kentucky taxes its residents on income earned on municipal bonds purchased from out-of-state issuers but not the income earned on Kentucky municipal bonds. Kentucky's exemption amounts to a subsidy of within-state bond holdings. Because the subsidy is limited to within-state bond holdings and excludes residents' interstate bond holdings, it is the equivalent of a tariff on imports of municipal bonds. It therefore discriminates against interstate commerce.

The selective exemption bears no economic resemblance to non-discriminatory policies by which Kentucky could promote its bonds to both residents and non-residents, such as coupons, rebates to all bondholders, or direct subsidies to municipalities.

(b) (i) The selective municipal bond tax exemptions adopted by Kentucky and 42 other states distort the interstate market for municipal bonds. More than one-third of the municipal bonds held through mutual funds and money-market funds have been invested in funds that specialize in holding a single state's bonds and marketing each state-specific fund primarily to residents of that state. This balkanization of the market along state lines has reduced consumer well-being, because the single-state bond funds suffer from limited diversification, poor liquidity, and high expenses.

(ii) The harm from Kentucky's selective exemption is reinforced, not offset, by the fact that most other states have adopted similar exemptions. Each state's exemption further balkanizes the market, causing greater cumulative harm to investors.

(iii) The purported benefit to Kentucky of lower financing costs is counterbalanced by the resulting lower tax revenues. Frequently, a state incurs net budgetary costs by granting a selective municipal bond tax exemption.

(iv) Moreover, even though the selective municipal bond tax exemption ultimately fails to lower the State's financing costs, Kentucky's selective exemption shifts costs to non-residents, who have no voice in the State's political processes. Non-residents who hold Kentucky bonds earn lower returns because the exemption drives down interest rates on Kentucky

bonds, but, unlike Kentucky residents, non-residents do not receive an offsetting tax exemption. In addition, non-residents are deterred from purchasing Kentucky bonds by the lower interest rates and the lack of an offsetting tax exemption, which deprives non-residents of the opportunity to diversify.

(c) The rule adopted by the court below would not require Kentucky to subsidize other states. Kentucky could determine to extend its exemption to out-of-state bonds, as well as home-state bonds, or to withdraw the exemption from both. If it were to extend the tax exemption to all bonds, it would subsidize only its residents' holdings of such bonds, not all bond holdings nationwide. More importantly, because other states would have the same choice to extend their exemption, cross-subsidies could develop nationwide. There would be no systematic transfer of resources from Kentucky to other states.

2. The Court should not extend the market-participant exception to the dormant Commerce Clause to protect the selective municipal bond tax exemption. The market-participant exception permits states to act in the market in the same way that private market participants might. In this case, Kentucky is using its tax power to discriminate in a manner that no private party ever could. Accordingly, the market-participant exception to the dormant Commerce Clause should not be enlarged to include the selective municipal bond tax exemption.

3. This Court's recent decision in *United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 127 S. Ct. 1786 (2007), also should not be expanded to protect the selective municipal bond tax exemption. *United Haulers* is inapposite because the statute upheld in that case

mandated use of a governmentally-operated business —a restriction that burdened within-state and interstate commerce alike. By contrast, Kentucky's tax scheme discriminates against interstate commerce and favors within-state commerce. Even if this Court were to conclude that *United Haulers* is relevant, this case should be remanded, not overturned. The Court issued its decision in *United Haulers* after the Kentucky Court of Appeals had decided this case, and the court below never had an opportunity to consider the import of that decision. Remand is particularly appropriate because the balancing test announced in *Pike v. Bruce Church, Inc.* 397 U.S. 137 (1970), applies if the selective exemption is analyzed under *United Haulers*, and the public policy *amici* submit that the selective municipal bond tax exemption fails that balancing test. The harms caused by the selective exemption far outweigh the doubtful benefits. Finally, it is uncontested that a substantial number of the municipal bonds at issue are actually "private activity" bonds, issued on behalf of private firms or non-profits. Bonds issued to assist in private financing do not come within the scope of *United Haulers*.

ARGUMENT

I. KENTUCKY'S SELECTIVE MUNICIPAL BOND TAX EXEMPTION DISCRIMINATES AGAINST INTERSTATE COMMERCE AND HAS, PREDICTABLY, LED TO HARMFUL MARKET BALKANIZATION.

A. Kentucky's Selective Tax Exemption Discriminates Against Interstate Commerce Because It Promotes Within-State Municipal Bond Holdings Over Interstate Holdings.

The Court scrutinizes a tax challenged under the Commerce Clause to ascertain whether it discriminates against interstate commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The Court has held that a state "tax may not discriminate between transactions on the basis of some interstate element," *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 332 n.12 (1977), and "may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State," *Armco Inc. v. Hardesty*, 467 U.S. 638, 642 (1984).

From the standpoint of basic economics, there can be no dispute that Kentucky's selective municipal bond tax exemption discriminates against interstate commerce. That state's exemption grants a tax reduction to Kentucky residents who purchase Kentucky municipal bonds. (The fact that the tax exemption applies to the interest income on bond holdings rather than directly to the purchase of the bond is economically irrelevant.) The State, however, provides no such tax break to Kentucky residents who buy municipal bonds issued by other states or, obviously, to non-residents who buy Kentucky mu-

nicipal bonds. As such, the tax break discriminates against interstate commerce because it is in effect a "within-state" subsidy, *i.e.*, a subsidy that is restricted to transactions that occur entirely within the state, with an in-state issuer and in-state purchaser. The Court has held that sort of tax subsidy to be a violation of the dormant Commerce Clause. *See Camps Newfound/ Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997).

From an economic viewpoint, a tax exemption functions like a subsidy. A broad-based subsidy to all purchasers or holders, just like a broad-based state sales tax on all purchases or holdings, typically poses no interstate commerce clause problem. This is because a subsidy on all purchases or holdings of a particular good by in-state parties does not discriminate on the basis of the location of the other parties to the transactions or the source of the good, either within and without the state. Such a subsidy is generally neutral with respect to interstate commerce. It applies equally to within-state transactions and holdings, on the one hand, as it does to transactions and holdings involving out-of-state parties on the other hand.

It is plain here that Kentucky's municipal bond tax exemption is properly characterized as a within-state subsidy that *does* discriminate against interstate commerce. When a state subsidizes within-state transactions but does not subsidize either imports or exports, then it encourages in-state purchasers to buy from in-state sellers and discourages them from buying from out-of-state sellers. Such a subsidy also decreases the ability of out-of-state purchasers to buy from in-state sellers, by increasing the price they pay and reducing the supply available to out-of-state

purchasers. The same holds true with respect to a subsidy of within-state holdings.

The case at hand therefore closely resembles *Camps Newfound/Owatonna, Inc.*, where this Court struck down a property tax exemption granted to camps that primarily served state residents. By subsidizing such camps, the tax exemption there in issue promoted within-state sales over interstate sales and thereby discriminated against interstate commerce. As the Court recognized, 520 U.S. at 580–81, this subsidy transformed what would have been a neutral property tax into a protectionist export tariff that discriminated against camps serving non-residents.

As with the *Camps* exemption, the economic objection to the selective exemption in this case is that Kentucky promotes only within-state holdings—*i.e.*, holdings of Kentucky bonds by Kentucky residents—and discourages out-of-state transactions, both exports of Kentucky bonds and imports of other states' bonds. Contrary to arguments by petitioners and supporting *amici*,[2] the exemption is therefore unlike

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[2] Eight *amicus* briefs in support of petitioners were filed with the Court. For the purpose of this brief, the public policy *amici* refer to each of the following briefs by the abbreviation in parentheses following the name: Brief for the Churchill Tax-Free Fund of Kentucky, *et al.* ("Churchill Br."); Brief for Dupree Mutual Funds ("Dupree Br."); Brief for the Government Finance Officers Association, *et al.* ("GFOA Br."); Brief for the Multistate Tax Commission ("MTC Br."); Brief for the National Association of State Treasurers ("NAST Br."); Brief for Nuveen Investments, Inc. ("Nuveen Br."); Brief for the Securities Industry and Financial Markets Association ("SIFMA Br."); Brief for State of North Carolina, *et al.* ("Br. 49 States").

In addition, one *amicus* brief was filed in support of neither party: Brief for the National Federation of Municipal Analysts ("NFMA Br.").

a discount, rebate or coupon, which would apply to all purchasers and so would be neutral between within-state and interstate transactions. (Pet. Br. 13; Dupree Br. 15.) Instead, the selective municipal bond tax exemption operates as a discriminatory tariff that gives state residents—and only state residents—an incentive to prefer in-state goods over out-of-state goods.

Likewise, the selective municipal bond tax exemption is not economically equivalent to a direct subsidy or cash payment by the Kentucky state government to municipal governments within the state. (GFOA Br. 20.) Though both arrangements provide a financial benefit to the municipality, the direct subsidy, unlike the tax exemption in issue, would create no incentive for Kentucky residents to prefer in-state bonds over out-of state bonds or disincentive for non-residents considering whether to purchase Kentucky bonds. A direct subsidy to municipalities, quite simply, would not discriminate against interstate commerce.

Accordingly, the objection to the selective municipal bond tax exemption from an economic viewpoint is *not* an objection to state favoritism of its own bonds. Rather, it is an objection to a form of favoritism that discriminates against interstate commerce. Kentucky may create rebates, discounts or coupons in conjunction with its bonds, offer attractive terms for its bonds, and advertise the merits of its bonds. Such practices do not discriminate against purchases and holdings by non-residents; they merely encourage everyone to purchase Kentucky bonds instead of other states' bonds. These forms of favoritism would be available to all purchasers and would encourage interstate commerce and in-state commerce equally.

Similarly, Kentucky may favor Kentucky residents over non-residents by subsidizing its residents' holdings of municipal bonds as long as that favoritism is in a form that does not discriminate against interstate commerce. If Kentucky does subsidize Kentucky bondholders, it must subsidize holdings of both out-of-state and home-state bonds. Instead, Kentucky has created an import tariff on out-of-state holdings by Kentucky residents. The selective tax exemption also has effects similar to an export tariff because it raises the price at which non-residents can purchase Kentucky bonds, as discussed in section I.B.4, *infra*. Such interference with interstate commerce (and the corresponding injury to consumer welfare outlined in Part I.B, *infra*) is exactly the kind of harm that the dormant Commerce Clause doctrine was developed to prevent.

B. Kentucky's Selective Tax Exemption, Together With Other States' Selective Tax Exemptions, Has Resulted In A Balkanized Municipal Bond Market That Harms All Bondholders And The States Themselves.

Kentucky's selective municipal bond tax exemption and the similar selective exemptions of other states have negative consequences for the national market for municipal bonds, consequences that are readily admitted by petitioners and the *amici* who filed briefs in support of petitioners. The states' discrimination against interstate transactions and holdings harms market participants, including the issuers of municipal bonds, and none of the justifications offered by petitioners or the *amici* supporting petitioners justifies or excuses balkanization of the market.

1. *The Selective Tax Exemption's Effects On The Interstate Municipal Bond Market Are Harmful To Consumers.*

The negative impact of the selective exemption on interstate commerce is far from theoretical. The petitioners themselves, as well as the *amici*, actually demonstrate that the selective exemption has balkanized the municipal bond market.

For example, the petition for certiorari concedes that the exemption encourages the concentration of in-state bond holdings: "The tax exemption influences a Kentucky resident to choose to acquire a bond issued by Kentucky or a Kentucky municipality over a bond issued by another state or other state's municipality that pays a higher rate of interest or has a stronger credit rating." (Cert. Pet. 12.) *Amici* supporting petitioners also acknowledge that the selective exemption promotes within-state holdings. (GFOA Br. 24–25; MTC Br. 13; SIFMA Br. 14; NAST Br. 27; Dupree Br. 7, Nuveen Br. 7, 16; Churchill Br. 6–7, 10.)

Over 600 single-state municipal bond funds (including both open-end mutual funds and closed-end funds) have been established to serve investors who live in a single state to encourage them to concentrate their holdings in that state's bonds. (Churchhill Br. 11.) In its *amicus* brief supporting neither party, the NFMA states that $155 billion of long-term municipal bonds are held in single-state mutual funds, about 42 percent of all long-term municipal bonds held in mutual funds. (NFMA Br. 11–12.) Also, $125 billion of short-term municipal bonds are held in single-state money-market funds, about 33 percent of the total short-term municipal bonds held

in money-market funds. (*Id.*) The NFMA suggests that a similar degree of within-state concentration prevails for bonds held outside of mutual funds and money-market funds. (*Id.* 12.) The NFMA's brief further predicts that most of the single-state funds would cease to be viable if selective municipal bond exemptions did not exist. (*Id.* 18.)

This Court has recognized that consumer welfare would be significantly reduced if each state had to obtain agricultural and manufactured products from its own farmers and firms. *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 539 (1949). The same principle applies equally to the market for municipal bonds. When every state attempts to obtain the bulk of its municipal financing from its own residents and to discourage them from purchasing municipal bonds issued by other states, similarly harmful economic consequences follow. The diversification, liquidity and cost savings offered by an unimpeded national municipal bond market are lost.

The NFMA details the impact of these exemptions in its brief, commenting, "[b]ecause of their sharply reduced geographical diversification and somewhat higher expense ratios relative to national funds (because the expense ratio is spread over a smaller asset base), single state funds appeal primarily to investors seeking to maximize their tax-exempt return." (NFMA Br. 13.) Thus, the NFMA acknowledges that balkanization has deprived consumers of diversification and has added expense. The NFMA further states that "national mutual funds place a higher premium on the liquidity of their holdings than do single state funds, which are willing to purchase less liquid bonds of smaller and less familiar issuers because of the state tax advantage." (NFMA Br. 19.)

Here the NFMA acknowledges that balkanization diminishes liquidity. The NFMA further acknowledges that balkanization has created wasteful overhead that could be decreased if there were an unimpeded national market, noting that "elimination of single state funds would lead to a reduction in the number of municipal mutual fund analysts employed within mutual fund complexes that offer a substantial number of such funds." (NFMA Br. 19.)

The NFMA does not express a view either way as to the desirability or undesirability of the status quo in the municipal bond market. The public policy *amici* here respectfully submit that the phenomenon the NFMA describes—higher costs to provide a less liquid and less diversified product—can only be viewed as a harm to investors caused by the balkanized condition of the market.

Petitioners and supporting *amici* argue that the states, as sovereigns, cannot compete against each other to provide essential public services such as police and fire protection. (Pet. Br. 27; MTC Br. 9–10.) That observation, though obviously true, is irrelevant to this case. The states do compete against each other in the municipal bond market to *finance* those services. They can and should compete on an equal basis without discriminating against interstate commerce. By inhibiting such competition and discriminating against interstate commerce, the selective municipal bond tax exemption has greatly reduced investor well-being.

2. *The Harm Caused By Any One State's Selective Tax Exemption Is Reinforced, Not Offset, By Other States' Selective Tax Exemptions.*

Amici supporting petitioners contend that the near universality of the selective municipal bond tax exemption resolves any problems posed by the exemption. (Nuveen Br. 9; SIFMA Br. 6–7; NAST Br. 28). This argument is premised on a misunderstanding of the economic objection to the selective exemption.

The problem is that the selective municipal bond tax exemption prefers within-state bond holdings over interstate bond holdings. That problem is reinforced, not offset, when other states adopt selective exemptions, because each state's residents own more of their own state's municipal bonds than they otherwise would, and the amount of interstate commerce is correspondingly reduced. Due to Kentucky's selective exemption, for example, Kentucky residents disproportionately hold Kentucky bonds, thereby reducing interstate holdings. Due to Ohio's selective exemption, Ohio residents disproportionately hold Ohio bonds, thereby further reducing interstate holdings. The same pattern holds in each of the states with selective exemptions. The fact that 43 states have selective exemptions does not mean that the playing field is almost level. Instead, it means that 43 playing fields are tilted towards within-state holdings and against interstate holdings.

The poor diversification, illiquidity, and high expenses caused by one state's selective tax exemption are not offset by the poor diversification, illiquidity, and high expenses caused by other states' selective tax exemptions. To the contrary, the greater the

number of states that carve out within-state markets, the more balkanized the municipal bond market becomes. Today's balkanized municipal bond market reflects the combined impact of 43 states' selective muncipal bond tax exemptions. The idea that the harm from one jurisdiction's trade restrictions can be offset by another jurisdiction's trade restrictions is not merely contradicted by mainstream economic theory, *see* Dennis R. Appleyard, *et al.*, INTERNATIONAL ECONOMICS 313 (5th ed. 2006), but has also been rejected by this Court. *See Great Atl. & Pac. Tea Co. v. Cottrell*, 424 U.S. 366, 378–81 (1976) (one state's trade barriers cannot be justified by the existence of other states' barriers).

3. *The Selective Tax Exemption Does Not Provide Any Offsetting Benefits Through Lower Financing Costs.*

Amici supporting petitioners argue that the selective exemption provides a potentially offsetting economic benefit to this market balkanization by lowering the State's financing costs. (MTC Br. 6; NAST Br. 29; Br. 49 States 10; GFOA Br. 24). Because the exemption increases demand for Kentucky bonds by making them more attractive to one set of potential holders (Kentucky residents), it lowers the interest rate that Kentucky must pay to sell its bonds. That does not obviously result in lower financing costs, however, since there is an offsetting loss of state tax revenue resulting from the exemption. The state effectively takes money out of one pocket and places it in another. At best, one would expect the within-state subsidy to be a wash economically.

Significantly, however, a state government may actually be worse off financially for choosing this

route to reduce its financing costs. Economists have observed a phenomenon known as the "muni bond puzzle" whereby states routinely fail to recoup the cost of the tax subsidy in the form of lower financing rates. *See* John Chalmers, *Default Risk Cannot Explain the Muni Puzzle: Evidence from Municipal Bonds that are Secured by U.S. Treasury Obligations*, 22 REV. FIN. STUD. 281, 282–83 (1998) (reviewing economics literature on the muni bond puzzle).[3] The purported benefits of this discriminatory tax system therefore in no way offset the observed harms.

4. *Kentucky's Selective Tax Exemption Imposes Costs On Non-Residents, Who Have No Voice In Its Political Processes.*

Although the selective tax exemption does not actually lower Kentucky's financing costs, it does shift costs to non-residents, contrary to the contention of petitioners and supporting *amici* that the costs of each state's exemption falls primarily or exclusively upon the state itself. (Pet. Br. 24–25; MTC Br. 13; GFOA Br. 20; NAST Br. 28.) Kentucky and the other states and supporting *amici* confirm that the selective tax exemption lowers the interest rates on municipal bonds. (Pet. Br. 23: GFOA Br. 17-18; Br. 49 States 9-10; NAST Br. 20; Dupree Br. 6; MTC Br. 6, 14.) The interest-rate reduction neces-

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[3] For an analysis that brings together the muni bond puzzle and the issues raised by this litigation, *see* Brian D. Galle & Ethan Yale, *Can Discriminatory State Taxation of Municipal Bonds be Justified? Thoughts on the* Davis *Topside Briefs*, 117 TAX NOTES (forthcoming Oct. 2007) (manuscript at 5–6 & n.8, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1014138).

sarily means that non-resident holders of Kentucky bonds are harmed by Kentucky's selective exemption because they receive a lower interest rate on Kentucky bonds with no offsetting subsidy. In addition, some non-residents who would otherwise have held Kentucky bonds choose not to do so in response to the lower interest rates and lack of tax exemption, thereby losing an opportunity to diversify their portfolios. Kentucky's selective exemption therefore imposes costs on non-resident holders and potential holders of its bonds, who have no voice in Kentucky's political processes.

C. Affirming The Court Below Would Not Require Kentucky To Subsidize Other States.

One other point of economic confusion should be addressed. *Amici* supporting petitioners contend that ruling in favor of respondents would unreasonably require Kentucky to subsidize other states. (MTC Br. 12, 14; Br. 49 States 11; Nuveen Br. 17.) That assertion is incorrect.

To begin, Kentucky would have a choice whether to continue exempting its residents' holdings of home-state municipal bonds and extend the same tax exemption to its residents' holdings of out-of-state bonds or to stop granting a tax exemption with respect to any bonds, whether out-of-state or with-in state. Kentucky is not required to subsidize other states, and the practical effect of a choice by Kentucky to exempt all municipal bond income from tax, including both home-state bonds and other states' bonds, would depend on how the other states react to the Court's ruling in this case. Other states would have the same choice as Kentucky. If other states determined to subsidize all municipal bonds held by

their residents, for example, cross subsidies among the states could occur and could work to Kentucky's advantage. In reality, if Kentucky extended its exemption to all municipal bonds, then all municipal bonds would become more attractive to Kentucky residents; and if other states did the same, then all municipal bonds would similarly become more attractive to their residents. Kentucky and the other states would likely be affected in similar ways: Each state's treasury would save financing costs from the interest-rate reduction, and each state's residents would earn lower interest rates on their bond holdings.

In any event, even if Kentucky were the only state to exempt all municipal bond income, the subsidy to other states would be limited to the holdings of Kentucky residents. Whenever a state subsidizes its residents' purchases of any good, out-of-state producers generally capture some of the gains. Such an effect cannot justify discrimination against interstate transactions.

II. THE MARKET-PARTICIPANT DOCTRINE SHOULD NOT BE EXTENDED TO UPHOLD THE SELECTIVE MUNICIPAL BOND TAX EXEMPTION.

The Kentucky Court of Appeals below declined to apply this Court's market participant doctrine on the ground that the State, by creating preferential tax treatment for its municipal bonds, had acted as a regulator rather than as a market participant. Petitioners and certain *amici* attack this distinction as formalistic. For example, Nuveen argues that Kentucky, as a market participant, would be "free to pay whatever rate of interest it wishes, to whomever it

wishes" under this Court's market participant precedents. (Nuveen Br. 3.) Nuveen concludes from this premise that "the Court of Appeals erred by refusing to acknowledge the economic reality of the Kentucky exemption, that is, the fact that the exemption is the functional equivalent of an additional interest payment" on state municipal bonds to state residents. (*Id.*)

Nuveen's argument and similar assertions by petitioners (Pet. Br. 41) are mistaken. There is a substantive distinction between a state's decision to discriminate against interstate commerce by means of its governmental taxing authority and a state's decision to discriminate as a market participant by paying different rates of interest to different holders. Through its use of the selective municipal bond tax exemption, Kentucky does not discriminate between in-state and out-of-state parties as a direct part of its market transaction. Rather, it uses the income tax system to discriminate after the market transaction has occurred and separate from it. Such a means of discrimination between in-state and out-of-state investors is simply not available to private parties. Indeed, given that participants in the public securities markets typically deal with each other in an impersonal manner without regard for the identities of counterparties, it is doubtful that private actors in this market could discriminate against the residents of other states even if they wanted to do so.

Petitioners' proposal that the Court allow the state to act as a "market participant" is therefore really a request that states be allowed to act in a way that no other market participant ever could. Such a request goes well beyond this Court's precedents. The market participant exception has been traditionally

justified by analogizing states to private market participants, with the implication that states should be as free to act in the market in the same manner as private parties. *Reeves, Inc. v. Stake*, 447 U.S. 429, 439 & n.12 (1980) (quoting *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919)). Accordingly, it is appropriate for the Court to decline to extend the exception to this context, where the State is attempting to discriminate against interstate interests in a manner that no private participant could. Certainly, the balkanization in the $2 trillion municipal bond market counsels against the extension of the market participant exception to these circumstances.

It is no response to argue, as Nuveen does, that if the State may permissibly discriminate by offering different interest rates to different bond holders, then the State should be able to reach the same result through an administratively more convenient method. (Nuveen Br. 8.) There is no reason for the Court to encourage such discrimination by permitting states to favor in-state interests through *any* means at their disposal, including a quintessentially regulatory means such as tax policy. As the Court said in *Camps*, 520 U.S. at 593, "A tax exemption is not the sort of direct state involvement in the market that falls within the market-participation doctrine."

The Court should therefore decline petitioners' request to extend the market participation doctrine in this context.

III. *UNITED HAULERS* DOES NOT VALIDATE THE SELECTIVE MUNICIPAL BOND TAX EXEMPTION.

In a recent decision, this Court upheld an ordinance requiring firms hauling waste in a county to

bring the waste to a publicly-owned facility. *See United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Man. Auth.*, 127 S. Ct. 1786 (2007). *United Haulers* announced a new exception to the dormant Commerce Clause, holding that a state may mandate that residents transact business with a state-run business if all private competitors, both in-state and out-of-state, are treated even-handedly. The public policy *amici* here respectfully submit that *United Haulers* does not apply to this case because the nature of the discrimination is quite different. In *United Haulers*, the ordinance at issue discriminated against *all* private trash haulers, whether local or out-of-state. By contrast, the selective municipal bond tax exemption discriminates directly against interstate commerce alone, creating a tax exemption that applies only to within-state municipal bond holdings. *United Haulers* is inapposite.

If the Court should nevertheless decide that *United Haulers* applies, the better course of action would be to remand the case to the Kentucky courts to consider the issue in the first instance. The Court decided *United Haulers* after the Kentucky Court of Appeals issued its decision, and the lower courts have not had a chance to consider the relevance, if any, of *United Haulers*. Prudence suggests that this Court wait to rule on an issue until it has been properly developed by the lowers courts. *See, e.g., Lockheed Corp. v. Spink*, 517 U.S. 882, 898 (1996) (Breyer, J., concurring in part and dissenting in part) (the Court should not reach a "highly technical" issue when it was not addressed by the lower courts); *Lebron v. National R.R. Passenger Corp.*, 513 U.S. 374, 407 (1995) (O'Connor, J., dissenting) ("we often defer consideration of novel questions of law to permit further development").

That course is particularly appropriate if the Court concludes that *United Haulers* might apply, given the plurality's decision that a court should use the balancing test derived from *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970), when applying *United Haulers*. That balancing test compares local benefits to the burden on interstate commerce. As explained above, the burden on interstate commerce is severe and has resulted in an inefficient balkanization of the municipal bond market, while the main alleged benefit of the selective exemption, lower financing costs, has not been demonstrated and is actually contradicted by the available evidence. Here, because *United Haulers* was not yet decided, the record has not been developed sufficiently to enable the application of the *Pike* test. *Cf. United Haulers*, 127 S. Ct. at 1797 (relying on lower-court findings based on "years of discovery" to support claimed local benefits).

Finally, the public policy *amici* note that roughly one-quarter of the municipal bonds in the market are "private activity" bonds, issued not on behalf of municipal governments, but on behalf of private businesses or non-profits. Private-activity bonds, are issued by state and local governments acting merely as conduits for non-governmental organizations. (NFMA Br. 6–7.) *See also* Joel Michael, Department of Revenue of Kentucky v. Davis: *Implications for State Tax Policy and Dormant Commerce Clause Doctrine*, 45 STATE TAX NOTES (forthcoming 2007) (manuscript at 13, *available at* papers.ssrn.com/sol3/papers.cfm? abstract_id=1005433). In *United Haulers*, this Court stressed that the exception discussed in that decision applies to state and local governments, not to private firms. 127 S. Ct. at 1795 ("Unlike private enterprise, government is vested with the responsibility of protecting the health, safety, and

welfare of its citizens. . . . Given these differences, it does not make sense to regard laws favoring local government and laws favoring private industry with equal skepticism."). With private-activity bonds, however, private parties are the actual borrowers, not state or local governments. The *United Haulers* exception should not apply in any event to this segment of the municipal bond market.

The Court should therefore decline to extend the *United Haulers* exception to Kentucky's selective municipal bond tax exemption.

CONCLUSION

For the reasons set forth above, the public policy *amici*, Messrs. Viard, Brill, DeMuth, Furman, Hassett, Hubbard, and Smetters, respectfully submit that the decision of the Court of Appeals of Kentucky should be affirmed.

Respectfully Submitted,

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